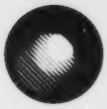
Tax Reform in Canada: the process and impact

Allan M. Maslove



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the process and impact

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Foreword

The federal government's two-part strategy of tax reform is now moving toward its conclusion. First, over the period from 1984 to 1987, income taxes were increased through a variety of measures; in 1988, reforms of the personal and corporate income tax were implemented to broaden the tax base and flatten the rate structure. Second, the federal manufacturers' sales tax was increased and the case for its integration with provincial sales taxes developed. In the summer of 1989, following the federal election and the failure of talks with provincial governments on the possibilities for such an integrated system, proposals for replacement of the highly selective manufacturers' sales tax by a more comprehensive federal goods and services tax were announced. At this writing, however, the final shape of the legislation for this purpose, intended to take effect on January 1, 1991, is not at all evident. It remains important, however, to have a clear understanding of the nature and likely impacts of the income tax reforms already in place, and it is to that goal that the studies described in this monograph are principally directed.

When it announced its plan for income tax reform in June 1987, the Government of Canada followed a path taken by most of the other western industrialized countries. Consistent with these other countries, the main thrust of tax reform in Canada was to reduce the inefficiencies associated with the income tax by eliminating 'loopholes' and lowering marginal rates. In addition, the Canadian reform was influenced by other factors particular to Canada, including our close economic links with the United States and the emerging Free Trade Agreement, the overall domestic agenda of the Conservative government, and our rather difficult history with earlier tax reform efforts.

This monograph contains two essays by Allan Maslove, a Scholar-in-Residence associated with the Institute's Studies in Social Policy Program and a Professor at

Carleton University. Together they address both the objectives and the process of tax reform and how those factors were reflected in the distributional impacts of the income tax reforms implemented to date. The author characterizes the results as the product of "very careful tax architecture".

The first essay casts the design of tax structure—and tax reform is nothing other than a considered alteration of tax structure—as striking a balance between the tax system as a mechanism to generate revenues for government and the tax system as a set of instruments for pursuing a variety of more fundamental public policy goals. As a revenue generator, the tax system should meet a number of criteria, including economic efficiency (tax neutrality), equity, simplicity, and predictability of revenue flows. Achieving all of these properties is far from straightforward; trade-offs are necessary (e.g., between efficiency and equity), and even specifying what a single criterion means (e.g., equity) may not be obvious.

Recognizing the tax system as a set of policy instruments employed in the pursuit of other government objectives complicates the design of tax structure still further. Governments use tax measures to stimulate desired economic activities (e.g., tax incentives to firms to conduct research and development), to promote socially desirable behaviour (e.g., tax credits for charitable donations), and to accommodate special circumstances (e.g., tax credits for large medical expenses). Accommodating these objectives while respecting the criteria noted in the previous paragraph leads to numerous inconsistencies and trade-offs. Tax incentives to spur investment in a particular sector or region, for example, deliberately introduce non-neutralities into the tax structure.

The author argues that, over time, as part of the normal budgetary process, the tax policy instruments become increasingly dominant and the criteria for revenue generation become increasingly compromised. This occurs because specific tax instruments advance the interests of particular groups in society, which press for the enactment and preservation of special measures in the tax code. On the other hand, there is no organized group (with the exception of the Finance Department itself) to defend the public interest in the tax system as an efficient revenue generator. In this context, tax reform can be seen as an exercise to reassert the principles of good revenue generation and to restore balance between these two broad functions of the tax system.

In reasserting the use of the tax system as a revenue generator, the government, in 1987, chose to emphasize economic efficiency or tax neutrality. That is, it sought to minimize tax considerations as factors in the economic decisions of individuals and firms. This tax reform exercise thus conforms to the general thrust of the Mulroney government's economic policy: minimizing the influence of government and strengthening market forces in an attempt to enhance economic growth and the competitiveness of the Canadian economy.

Previous attempts to reform the income tax system have not been successful largely because of the array of groups fighting to maintain vested interests in the existing tax structure, combined with the inability of governments to mobilize general support for the thrust of the proposed tax reform. The income tax reform of 1987-88 was, by historical

standards, politically successful because the government was better at managing the reform process. In addition, the American tax reform of 1986 provided a general model that was supported by many interest groups and created a sense of urgency that the Canadian reform could not be allowed to drag on for years. A final factor, Maslove argues, is that the 1987-88 reforms are not as far-reaching as they appear at first blush and thus do less to disturb vested interests than did previous reform attempts.

This first essay concludes with the suggestion that a permanent body be established to conduct research and publish information to strengthen the consideration of the general public interest in fair and efficient taxation. Maintaining a better balance over time, it is argued, would ease the disruption and uncertainty that are inevitably created by major episodic tax reform exercises.

The 1987-88 income tax reform brought to the fore the inevitable focus on equity and the public's concern with who pays. This issue is addressed in the second essay in this volume, which reports the results of a micro-simulation analysis of the distributive impacts of the changes in the personal income tax system from 1984 through tax reform in 1988.

The micro-simulation was conducted using the Statistics Canada Social Policy Simulation Database/Model (SPSD/M) which contains data on approximately 100,000 individual Canadians in more than 40,000 households. The incomes received by these individuals in 1984 form the basis of these simulations; this income profile is constant throughout all the tax scenario simulations (except for some minor changes reflecting transfer payment adjustments between 1984 and 1988). Three tax scenarios are simulated. The first is the 1984 personal income tax system as it actually existed. Second, the analysis simulates the impact of the tax system as it would have been in 1988 without tax reform. Third, the analysis simulates the impact of the fully implemented post-reform system. All three tax systems are examined as if they had been levied against the 1984 income profile. Thus, by comparing the three simulations, the paper provides an analysis of what would have happened to the distribution of tax burdens from 1984 through tax reform alone, assuming no changes in incomes either as a consequence of economic growth or as a consequence of changes in behaviour induced by changes in the tax system.

The results indicate that the personal income tax changes involved in moving from the 1984 system to the 1988 (pre-reform) system reduced the disposable incomes of all taxpayers except those in the lowest 20 per cent of the income spectrum. The average decline in disposable income was about $800. Tax reform then increased disposable incomes for all income groups; nevertheless, on average only about half the previous decline was recouped. Overall, with the change from the 1984 system to the reformed system, the lowest 20 per cent and the top 1 per cent of income recipients became better off. In absolute dollar terms, individuals in the top 1 per cent income group were the biggest gainers by a large margin. Beyond these general results, one notable group of gainers was the Old Age Security population; in these simulations about 80 per cent of this group showed higher disposable incomes after tax reform.

To estimate horizontal equity properties, the analysis also examined the range of effective average tax rates for taxpayers at given points in the income spectrum. The range of dispersion did not change appreciably with tax reform. Finally, the analysis examined the impact on marginal tax rates. Effective marginal tax rates, being affected by a variety of direct spending programs that include their own (often implicit) taxback provisions, are much more complicated than one might expect from examining statutory tax rates alone. It is an important strength of the SPSD/M system that it permits independent analysts to bring into distributional analysis of the sort reported here these additional impacts and interactions.

Overall, Professor Maslove concludes that in its income tax reform, the Mulroney government was pursuing a clear agenda consistent with its general aim of strengthening market forces. Accordingly, the government's intention was to strengthen incentives, particularly incentives to save and invest, by removing or weakening preferential tax measures, broadening the tax base and lowering marginal rates. The resulting distributional impacts—controversial as they may be—reflect these moves.

In publishing this volume the Institute hopes to contribute constructively to the important public debate on the structure of the Canadian tax system and to provide the foundation for a more comprehensive analysis of distributional impacts. This can be completed only when the exact shape of the second stage of the government's tax reform strategy—the introduction of a federal goods and services tax—is finally known.

Rod Dobell, President

September 1989

Avant-propos

La stratégie de réforme fiscale en deux étapes du gouvernement fédéral approche de son terme. Dans un premier temps, de 1984 à 1987, on a d'abord procédé à une augmentation de l'impôt sur le revenu au moyen de diverses mesures; en 1988 l'impôt sur le revenu des particuliers et des sociétés était amendé afin d'élargir l'assiette fiscale et d'aplanir la structure des taux d'imposition. Dans un deuxième temps, la taxe fédérale de vente au départ de l'usine a été augmentée et des mesures ont été envisagées pour tenter d'y intégrer les taxes provinciales. Au cours de l'été 89, suite aux élections fédérales et à l'échec des pourparlers avec les gouvernements provinciaux sur les moyens d'établir un tel système intégré, le gouvernement a annoncé qu'il avait l'intention de remplacer la taxe de vente au départ d'usine, qu'il jugeait trop sélective, par une taxe fédérale généralisée sur les biens et services. À l'heure actuelle, cependant, la version définitive de la législation devant être établie à cet effet pour entrer en vigueur le 1er janvier 1991 est loin d'être au point. Il demeure toutefois essentiel de se faire une idée précise de la nature et des conséquences probables des réformes de l'impôt sur le revenu déjà en place. C'est l'objectif principal visé par les études décrites dans la présente monographie.

En annonçant son plan de réforme de l'impôt sur le revenu en 1987, le gouvernement du Canada ne faisait que suivre l'exemple de la plupart des pays industrialisés de l'Ouest. À l'instar de ces pays, la réforme fiscale canadienne visait à réduire les faiblesses du système en éliminant les échappatoires et en abaissant les taux les plus élevés. Cette réforme était en outre influencée par d'autres facteurs proprement canadiens, tels que nos liens économiques étroits avec les États-Unis et l'Accord de libre-échange sur le point d'être signé, le calendrier de travail général du gouvernement conservateur et nos expériences antérieures plutôt difficiles dans le domaine des réformes fiscales.

Cette monographie contient deux études de Allan Maslove, chercheur invité dans le cadre du programme de recherches en politique sociale de l'Institut et professeur à l'Université Carleton. Les deux essais traitent des objectifs de la réforme fiscale ainsi que de son processus et de la manière dont ces deux facteurs sont reflétés dans les effets distributionnels des réformes fiscales réalisées à ce jour. L'auteur caractérise les résultats d'"architecture fiscale très soigneuse".

Le premier essai définit le schéma de la structure fiscale (et la réforme fiscale n'est rien d'autre qu'une tentative de réaménagement de la structure fiscale) comme le moyen de réaliser un équilibre entre la conception d'un système fiscal générateur de revenus pour le gouvernement et celle d'un système fiscal permettant à celui-ci de poursuivre une variété d'objectifs de politique générale plus fondamentaux. En tant que producteur de revenus, le système fiscal devrait satisfaire à un certain nombre de critères tels que : l'efficacité économique (neutralité fiscale), l'équité, la simplicité et le caractère prévisible des rentrées d'argent. Cet idéal n'est pas simple à réaliser : les compromis sont nécessaires (par exemple entre l'efficacité et l'équité) et l'établissement même de ce que chacun de ces critères représente (par exemple l'équité) peut s'avérer difficile.

Par ailleurs, la conception du système fiscal comme un ensemble de moyens mis à la disposition du gouvernement pour réaliser d'autres objectifs en complique encore plus la structure. Les gouvernements emploient des mesures fiscales pour stimuler les activités économiques désirées (par exemple les dégrèvements d'impôts accordés aux compagnies pour leurs activités dans le domaine de la recherche et du développement), pour promouvoir un comportement socialement souhaitable (par exemple les dégrèvements pour donations charitables) et pour apporter une aide dans les situations exceptionnelles (par exemple en cas de frais médicaux importants). La compatibilité entre ces objectifs et ceux du paragraphe précédent entraîne bien des contradictions et des compromis. Par exemple, les stimulants fiscaux destinés à promouvoir les investissements dans un secteur donné ou une région particulière constituent une infraction délibérée au principe de neutralité économique en matière de structure fiscale.

L'auteur pense que les instruments de politique fiscale, en tant qu'ils appartiennent au processus budgétaire normal, finissent par dominer de plus en plus avec le temps, et ce au détriment de cet autre aspect du processus fiscal qui est la production des revenus. Cela tient au fait que les mesures fiscales spécifiques profitent à certains groupes dans la société et que ceux-ci font pression pour l'établissement et le maintien de ces mesures particulières dans le code des impôts. Par ailleurs, il n'existe pas de groupe organisé (à l'exception du ministère des Finances lui-même) prêt à défendre l'intérêt public d'avoir un système fiscal efficace dans la collection des revenus de l'État. Dans cette conjoncture, on peut considérer la réforme fiscale comme une tentative visant à rétablir les principes d'une saine production de revenus pour l'État et à restaurer l'équilibre entre les deux fonctions principales du système fiscal.

En rétablissant la fonction génératrice de revenus du système fiscal en 1987, le gouvernement a choisi de mettre l'accent sur l'efficacité économique, c'est-à-dire sur le caractère neutre de l'impôt. Il a donc essayé de minimiser le rôle que devraient jouer les considérations d'ordre fiscal dans les décisions économiques des particuliers et des entreprises. Cette attitude est conforme à la direction d'ensemble que le gouvernement

Mulroney entend donner à sa politique économique, à savoir : la réduction de l'influence du gouvernement et le renforcement des forces du marché pour accroître l'expansion économique et la compétitivité de l'économie canadienne.

L'échec répété des tentatives antérieures de réforme fiscale est en grande partie dû aux nombreux groupes de pression qui ont tout fait pour conserver leurs droits acquis dans le système fiscal, ainsi qu'à l'incapacité des divers gouvernements à susciter l'intérêt général pour la mise en application des réformes fiscales proposées. La réforme de l'impôt sur le revenu de 1987-88 a été, par comparaison, un succès politique parce que le gouvernement a mieux réussi à organiser le processus de réforme. En outre, la réforme fiscale américaine de 1986 a fourni un modèle qui avait le soutien d'un grand nombre de groupes d'intérêt : on s'est rendu compte qu'il devenait urgent de procéder à une réforme fiscale au Canada et qu'on ne pouvait pas se payer le luxe d'attendre beaucoup plus longtemps. Enfin, M. Maslove relève une dernière raison de ce succès politique : c'est que les réformes de 1987-88 ne sont pas aussi radicales qu'elle semblent l'être à première vue et que, par conséquent, elles dérangent moins les intérêts acquis que ne le faisaient les tentatives de réforme antérieures.

En conclusion, dans ce premier essai, l'auteur suggère de créer un organisme permanent, avec pour mission d'effectuer des recherches et de publier des données pour en arriver à un système d'imposition juste et efficace qui tienne compte de l'intérêt public général. Le maintien d'un meilleur équilibre au cours des ans, fait remarquer l'auteur, atténuerait les effets de rupture et d'incertitude qui sont inévitablement créés par la mise en oeuvre périodique des réformes fiscales.

La réforme de l'impôt sur le revenu de 1987-88 a mis en lumière l'inévitable question de l'équité et celle de savoir qui va en faire les frais. Ce problème fait l'objet du second essai de ce volume; l'auteur y présente le compte rendu d'une analyse en microsimulation des effets distributionnels des changements survenus dans le système de l'impôt sur le revenu des particuliers, de 1984 à la réforme de 1988.

La microsimulation a été conduite à partir d'un modèle de base de données de Statistiques Canada destiné à permettre des études de politique sociale en simulation (en anglais : SPSD/M). Ce modèle contient des données sur environ 100 000 Canadiens répartis dans plus de 40 000 foyers. Les revenus perçus par ces particuliers, en 1984, servent de base aux diverses simulations; le profil des revenus demeure constant pour toutes les simulations des différents scénarios de la fiscalité (à l'exception de quelques modifications mineures apportées pour tenir compte des ajustements de paiements de transfert, entre 1984 et 1988). Trois scénarios sont imaginés. Le premier représente le système de l'impôt sur le revenu des personnes de 1984, tel qu'il a véritablement existé. Le second analyse en simulation l'impact du système fiscal tel qu'il aurait été en 1988 sans réforme fiscale. Le troisième analyse en simulation l'effet d'un système fiscal entièrement mis en oeuvre après la réforme. Les trois systèmes fiscaux sont examinés en fonction du profil des revenus de l'année 1984. Ainsi, en comparant les trois simulations, l'étude fait ressortir une analyse de ce qui se serait produit dans la répartition du fardeau de l'imposition depuis 1984 en ne tenant compte que de la seule réforme fiscale et en supposant qu'il n'y aurait eu aucun changement dans les revenus, soit du fait de la

croissance économique, soit du fait de changements dans les comportements à la suite des transformations dans le système fiscal.

Les résultats indiquent que les changements dans les impôts sur le revenu personnels entre le système de 1984 et celui de 1988 (avant la réforme) ont eu pour effet de réduire le revenu disponible de tous les contribuables, à l'exception de ceux qui se trouvent dans la tranche de 20% des revenus les plus bas. La diminution moyenne du revenu était de l'ordre de 800$. La réforme fiscale a eu pour conséquence une augmentation du revenu disponible pour tous les groupes; néanmoins, cette augmentation n'a permis de récupérer qu'environ la moitié, en moyenne, de ce qui avait été perdu auparavant. Dans l'ensemble, de la situation de 1984 au système réformé, seuls les revenus dans la plus basse tranche de 20% et ceux de la tranche la plus élevée de 1% se sont trouvé avantagés. En valeur absolue, les individus appartenant à la tranche la plus élevée de 1% se sont révélé être, de loin, les plus grands bénéficiaires. En dehors de ces résultats d'ensemble, il est à noter que le groupe des retraités apparaissait avantagé; selon ces simulations, environ 80% des personnes appartenant à ce groupe ont bénéficié de revenus disponibles plus élevés après la mise en oeuvre de la réforme.

Pour estimer l'équité sur le plan horizontal, l'analyse a porté sur l'échelle des taux moyens réels d'imposition des contribuables pour différentes tranches de revenus. Il apparaît que l'échelle de dispersion n'a pas vraiment changé après la réforme fiscale. Pour finir, l'analyse a porté sur les taux d'imposition les plus élevés. Ceux-ci, étant affectés par une variété de programmes de dépenses directes qui comprennent leurs propres dispositions pour le remboursement des impôts (provisions souvent implicites), sont beaucoup plus compliqués qu'on pourrait s'y attendre en ne consultant que les taux statutaires. C'est un des atouts du modèle SPSD/M de laisser aux analystes indépendants la possibilité d'intégrer, dans le type d'analyse distributionnelle dont il est question ici, ces effets additionnels et ces interactions.

Dans l'ensemble, conclut le professeur Maslove, le gouvernement Mulroney, avec sa réforme de l'impôt sur le revenu, a poursuivi un programme d'action tout à fait dans la ligne de son objectif global visant à affermir les forces du marché. Dans cette optique, le gouvernement s'est efforcé de favoriser les stimulants économiques, notamment ceux favorisant l'épargne et les investissements; pour ce faire, il a élargi l'assiette de l'impôt et abaissé les taux d'imposition les plus élevés. Les conséquences de cette politique sur la distribution des revenus, en dépit de la controverse, reflètent bien les intentions du gouvernement.

En publiant ce volume, l'Institut espère contribuer d'une manière positive à l'important débat public sur la structure du système fiscal canadien. Il espère également fournir les assises nécessaires à une analyse plus complète des effets distributionnels de ce système. Ceci ne pourra toutefois se faire que lorsque nous aurons une meilleure idée de la physionomie que prendra la seconde étape de la stratégie de la réforme fiscale du gouvernement, c'est-à-dire après l'introduction de la taxe fédérale sur les biens et services.

Rod Dobell, président

Septembre 1989

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Finally, as always, I am responsible for the analysis contained in this monograph and for the conclusions drawn from it.

Allan M. Maslove
Ottawa
September 1989

Introduction

On June 18, 1987, after much advance notice and signalling of intentions, the Progressive Conservative government introduced its tax reform plan in the form of a White Paper. Students of Canadian public policy would have to look hard to find a policy area that encompasses as many of the facets of government as taxation and tax reform do. Understanding the structure of the tax system, and its re-structuring, requires one to understand the relationships between economic management on both the macro and micro levels, interest group politics, partisan politics, and more.

The White Paper split the reform into two distinct stages. The first stage, involving changes to the personal and corporate income taxes, was to be implemented for the 1988 taxation year. Legislation was introduced in December 1987 and enacted in the summer of 1988 prior to the election call. The second stage, the overhaul of the federal sales tax and some further income tax adjustments, would be deferred to some indefinite time in the future. At that time, few specifics were provided about the second stage.

The first stage changes in the personal income tax were of three types. First, many deductions and exemptions were converted to tax credits; including the basic personal, spousal and child exemptions; the age and disability exemptions; and the medical expense, charitable donations, tuition fee, pension income, UI premium and CPP/QPP deductions. The second component was the elimination of several provisions in order to expand the tax base. These included the $1000 investment income deduction, MURBs, the special treatment for investment in Canadian films, and a reduction in the capital gains exemption from 50% to 25% (in stages). The $500,000 lifetime capital gains exemption introduced in 1985 was also limited to $100,000 for most types of capital gains. Finally, there were major changes in the rate structure and alterations in the refundable

tax credits available to low-income tax filers. The ten marginal rate brackets in the old system were collapsed into three brackets—17%, 26%, and 29% (federal rates only).

Changes in the corporate income tax were generally in the direction of broadening the base by eliminating special provisions and lowering tax rates.

The two papers in this volume address the process of tax reform and its fiscal impacts on families at different levels of income. Taken together, these analyses suggest that the tax reform of 1987-88 is the product of very careful tax architecture.

The first paper, which examines the tax reform process, argues that of the government's three primary objectives in tax reform—efficiency or tax neutrality, equity, and simplicity—concern with efficiency was dominant. The intention of the government when it embarked on tax reform was to remove or reduce the influence of the tax system on private sector decision making and to enhance the influence of market forces in these decisions. More specifically, the government wanted to strengthen incentives for work, and especially for investment, in order to stimulate economic growth. This was to be accomplished by eliminating or weakening special provisions that distorted (often deliberately) investment and labour supply decisions, and by reducing tax rates and tax burdens to improve incentives.

The second paper focuses on the concern for tax equity. It examines the distributional impacts of the personal income tax changes. The pattern that emerges reflects the government's focus on efficiency, with equity concerns entering largely as constraints on the design of the new tax system. The top 1% of family units received the largest benefits as a result of tax reform. Given the objective of reducing the influence of the tax system as a factor in saving and investment decisions, one would expect that the most significant reform measures would affect individuals in a position to adjust their behaviour in response to the new tax system. Strategic considerations would suggest that tax reform focus on groups with the flexibility and resources to respond to altered incentives. Clearly these taxpayers are in a strong position to adjust their economic behaviour, particularly their investment behaviour. Our results indicate that they have been given the strongest incentives to do just that.

It is also noteworthy that the movement in this direction was not more far-reaching. The top 1% group appears to be the only one in the upper portions of the income spectrum clearly to benefit. Moreover, changes in marginal tax rates, while generally in the desired direction, were quite moderate. In short, the results suggest that the tax reform may not have gone far enough to achieve the government's own primary objective. While most deductions and exemptions were converted to tax credits, few were eliminated. The broadening of the personal income tax base was therefore quite modest; as a result, the scope available for lowering tax rates was also limited. The room to lower rates that was created was allotted, for the most part, to the highest income earners.

This moderation in tax reform may, in turn, be explained by the strength of the *status quo* (discussed in the first paper). Previous attempts to broaden tax bases (remove tax preferences) have created a great deal of difficulty for governments. These problems can be avoided, or at least limited, by enacting less radical reforms. And indeed, the

Mulroney government has been more politically successful with its income tax reforms than its predecessors in 1970-71 and 1981. Ultimately then, the government's success and lack of success are attributable to the same forces.

While focusing on its primary objective (tax neutrality), the government clearly saw the need to protect, and if possible to enhance, the position of highly visible groups in society that were commonly regarded as being disadvantaged. The simulation results show this strategy at work most clearly with respect to the low-income elderly population, but also with low-income families with children.

These changes must of necessity leave others to bear the burden of adjustment. This was achieved partly by shifting approximately $2.4 billion annually out of the personal income tax to other tax revenue sources (compared to 1988 without reform), and partly by increasing the tax burden on a broad range of middle-income taxpayers.

I
The Process of Tax Reform

This paper discusses the forces that came into play in the 1987 tax reform exercise. It compares the 1987 reform to previous exercises and addresses the question of whether the Canadian public is well served by the process as it now stands or whether some institutional changes might improve the process and the outcome. The next section provides a brief introduction to the history of earlier tax reform efforts in Canada, particularly with respect to the income tax. The second section offers a perspective on the tax system that is essential to understanding the historical reform pattern as well as the current program of reform. In the third main section a conceptual framework is developed with which the observed pattern of taxation might be better understood. The next two sections of the paper focus on the current reform exercise, the first discussing the factors that brought tax reform to the public policy agenda, and the second discussing the goals of the government and the process it adopted.

Historical Overview

Income taxation was introduced in Canada in 1917. Prior to that year, virtually all federal revenues were generated by customs duties and excise taxes. The personal and corporate income taxes were introduced at a time when the government faced heavy financial demands as a result of Canada's war effort. Opinions were changing in favour of income taxation because it was seen in part as an appropriate companion to conscription and in part as an equitable response to the high incomes that some enjoyed as a result of the war.[1] As Table 1.1 indicates, without the revenue from these taxes, more than half of

Table 1.1
Composition of Total Financial Requirements – Government of Canada
(cash flow basis – percentage distribution)

Year	Customs Duties	Excise Duties	Sales Tax	Personal Inc. Tax(1)	Corp. Inc. Tax(1)	Unemploy Insur.	Other Revenues	Deficit(2)	Total
1868	63.7	22.2					14.1	0.0	100.0
1880	44.0	13.1					13.5	29.4	100.0
1900	58.1	20.4					22.9	-1.4	100.0
1910	54.6	13.9					21.7	9.8	100.0
1917	28.0	5.1					14.7	52.2	100.0
1920	23.4	5.9		1.8	0.9		13.9	54.1	100.0
1930	45.4	16.4	11.2	6.9	10.6		20.6	-11.1	100.0
1940	16.3	9.5	21.5	7.1	12.2		14.8	18.6	100.0
1950	9.7	9.5	17.3	26.7	25.9	4.5	13.7	-7.3	100.0
1960	8.2	5.3	15.7	27.5	19.3	3.6	11.6	8.7	100.0
1967	7.9	4.7	21.1	31.1	17.8	3.5	10.7	3.2	100.0
1970	6.1	3.9	17.2	38.3	21.7	4.4	11.3	-2.9	100.0
1975	5.6	2.3	15.0	41.5	16.7	5.0	10.2	3.7	100.0
1980	5.8	1.7	9.2	32.8	13.5	5.2	9.7	22.1	100.0
1985	3.2	1.3	6.5	25.1	8.0	6.7	16.4	32.8	100.0
1986	3.4	1.3	8.0	28.2	7.9	7.7	14.1	29.4	100.0

1 Includes old age security taxes in relevant years.

2 Negative sign indicates surplus.

Source: 1868-1967 – Gillespie, "The Birth, Growth and Death of Taxes", Carleton University, mimeo, 1985.
1968-1986 – Hettich and Winer, "The Evolution of Revenue Systems: A Theoretical and Empirical Investigation", Carleton Economic Papers, May 1987.

federal spending was being financed by deficits. Table 1.2 provides an overview of the importance of these new taxes in terms of the shares of revenue they provided, although a good deal of variation often existed in the years between those displayed in the table.[2]

Initially, as Tables 1.1 and 1.2 show, the corporate income tax (CIT) generated about as much or more revenue than the personal income tax (PIT), and by about 1950 they became the two largest revenue sources of the federal government. A few years later, the PIT clearly came to dominate the CIT in terms of revenue yield, as the latter began to decline continuously and dramatically in relative terms.

Until the late 1930s individuals and corporations in Canada faced separate federal and provincial income taxes and, in some cases, a municipal income tax as well. This situation, which has been characterized as a "tax jungle", came under severe strain during the Great Depression, particularly with respect to the financing of unemployment relief. Federal and provincial efforts to alleviate these problems resulted in the first tax collection agreements in 1936. Generally these arrangements involved the harmonization of the provincial tax base with the federal, the elimination of separate municipal income taxes where they existed, and federal collection of revenues on behalf of the provinces. The movement towards these arrangements was given an important legitimization by the recommendations of the Rowell-Sirois Royal Commission in 1940. During the Second World War, the federal government assumed sole occupancy of the income tax, and the collection agreements with the provinces were replaced with tax rental agreements. As the heavy wartime and post-war financing requirements eased, tax collection agreements were again reached along the lines recommended by the Rowell-Sirois Report.[3]

Other than the federal-provincial agreements, there were a few modest changes in the structure of the income tax in the early post-war period. The first full-scale re-examination of the country's tax system began in 1962. In that year Prime Minister Diefenbaker appointed a Royal Commission on Taxation under the chairmanship of Kenneth Carter, a leading member of the Canadian accounting profession. The Commission engaged in extensive public hearings and undertook a major research program on the Canadian tax system. Its report, issued early in 1967, focused on income as the most appropriate basis for taxation and emphasized equity as the primary criterion for taxation.

More specifically, the Carter report gave primacy to the personal income tax within the federal tax system. It proposed the integration of the personal and corporate income taxes, which essentially meant the attribution of corporate earnings to individual shareholders. (A distinct corporate income tax would still have remained in place for foreign shareholders and institutional shareholders.) A major reduction of the reliance on sales taxes was also recommended. All income (including capital gains) was to be taxed equally, and the highest marginal tax rate was to be set at 50%.[4]

Table 1.2
Composition of Revenues (excluding Deficits) – Government of Canada
(cash flow basis – percentage distribution)

Year	Customs Duties	Excise Duties	Sales Tax	Personal Inc. Tax	Corp. Inc. Tax	Unemploy Insur.	Other Revenues	Total
1868	63.7	22.2					14.1	100.0
1880	62.3	18.6					19.1	100.0
1900	57.3	20.1					22.6	100.0
1910	60.5	15.4					24.1	100.0
1917	58.6	10.7					30.8	100.0
1920	51.0	12.9		3.9	2.0		30.3	100.0
1930	40.9	14.8	10.1	6.2	9.5		28.1	100.0
1940	20.0	11.7	26.4	8.7	15.0		18.2	100.0
1950	9.0	8.9	16.1	24.9	24.1	4.2	12.8	100.0
1960	9.0	5.8	17.3	30.2	21.2	3.9	12.7	100.0
1967	8.2	4.9	21.8	32.1	18.4	3.6	11.1	100.0
1970	5.9	3.8	16.7	37.2	21.1	4.3	11.0	100.0
1975	5.8	2.4	15.6	43.1	17.3	5.2	10.6	100.0
1980	7.4	2.2	11.8	42.1	17.3	6.7	12.5	100.0
1985	4.8	1.9	9.7	37.4	11.9	10.0	24.4	100.0
1986	4.8	1.8	11.3	39.9	11.2	10.9	20.0	100.0

Source: See Table 1.1.

Following publication of the report, the government invited comments in advance of announcing its intentions in a White Paper. The response from critics, who mainly represented business interests, was strong indeed. The main criticisms centred around the proposals to tax all economic sectors more evenly. Not unexpectedly, those that were currently enjoying preferential treatment, especially the mineral extraction industries, were strongly opposed to these proposals. The recommendations to tax capital income at rates more comparable to labour income, and the proposals on capital gains taxation in particular, came under heavy attack.

Following this opportunity for public comment, the government tabled its White Paper in late 1969. Broadly speaking, the White Paper followed the themes of the Carter report but with considerably watered down policy recommendations. The government then called for another round of public consultations. Two parliamentary committees, the House of Commons Standing Committee on Finance, Trade and Economic Affairs and the Senate Committee on Banking, Trade and Commerce, received submissions from interested parties and held public hearings. The government's intention was to use this extensive public debate to secure broad consensus on the final tax legislation and to develop a politically acceptable tax reform plan.

In actuality, the public debates were dominated by the interest groups that stood to lose the most from the reform proposals. For example, submissions from industry groups and associations opposed a single tax rate for all corporations and the proposed five-year revaluation of shares for capital gains purposes. However, no group was more adamant than the mineral extraction industry.[5] The industry went so far as to threaten a "capital strike" if the proposed changes were enacted.[6] The determination of these interests was reflected not only in the vehemence of their attacks, but also in their volume. The Commons Committee heard 214 presentations in its hearings; 43 of these, about 20%, were primarily interested in overturning the mineral tax proposals.[7]

Several provincial governments also played an active role in the debates, essentially becoming intervenors on behalf of industries that were important to their respective regional economies. Some intervened on behalf of the mineral industries, while some argued against personal and corporate tax integration. The Senate Committee's report noted:

> It is significant that in the briefs published by the various provinces in recent months, the two items in the White Paper that were most strenuously objected to were integration and the proposed treatment of [the] mining and oil and gas industries. These industries are so important to the economy of the respective provinces in their continued development and expansion and so necessary for regional development that the provinces have expressed great concern as to the adverse consequences of the White Paper proposals relating to these industries and their effect on the economy of the provinces.[8]

The pressure from these interventions and the almost complete absence of interventions in support of the proposals lead the Finance Minister, Edgar Benson, to revise the White Paper proposals affecting mineral extraction in the summer of 1970, even before the parliamentary committees published their reports. These revisions removed most of the additional tax burdens that were in the White Paper proposals.

When the actual legislation was introduced in 1971, these concessions were included with only slight modifications.

Part of the reason for the federal government's retreat was its desire to maintain the tax agreements with the provinces that existed at the outset of the reform exercise. As noted by Bucovetsky, "[a] major concern throughout the federal tax reform process was that the tax system which emerged must preserve the advantages of the existing system under which provincial governments levied income taxes on the same basis as the national government. It was this concern that gave provinces substantial veto power over federal tax design."[9]

The reform of the tax system that was finally enacted in 1971 and became effective in 1972 was only a pale reflection of the Carter Commission's recommendations, which had been received so enthusiastically by academics and other students of taxation. The pressure brought to bear by the potential losers in the exercise forced the government to retreat from the Carter design, first in its White Paper and again in the final legislation. In large part, the reason for this outcome was the virtual monopolization of the public consultation process by interests with tax privileges to protect and the absence of effective voices in support of the reforms proposed in the Carter report. The former group was small in number, easily organized and had a large financial stake in the outcome. The latter group, those who stood to gain from the original tax reform plan, was larger in number but harder to organize and, comparatively, their potential gains were individually small. No organization or institutional mechanism existed that could have served as a locus around which these interests could have coalesced to participate effectively in the tax reform debate.

The decade following the Carter reform exercise saw the addition and enrichment of several important tax expenditures. Among these were accelerated depreciation for manufacturing machinery and equipment, lower corporate tax rates for manufacturing enterprises, the interest and dividend deduction, the retirement savings plan deductions, the Registered Home Ownership Savings Plan, investment tax credits, inventory allowances, and the Refundable Child Tax Credit. In addition, other structural changes were introduced, the most important of which was the inflation indexing of exemptions and tax brackets, introduced in 1974.[10]

The next significant attempt to reform the income tax was embodied in the November 1981 budget of Finance Minister Allan MacEachen. MacEachen proposed the elimination or restriction of several tax expenditures, including income averaging provisions, the non-taxation of certain employee benefits, the treatment of interest expenses, and the capital gains exemption. The proposals would have increased federal revenues by about $2 billion annually; the budget proposed to "spend" about half that amount to reduce some marginal tax rates. The remainder was to be realized in actual revenues in order to reduce the federal deficit. The marginal rate reductions in the budget were restricted virtually entirely to the top two income tax brackets.

The 1981 tax reform process was almost the direct opposite of the Carter exercise. The MacEachen reforms were developed in the traditional secrecy that is part and parcel of the budgetary process[11] and were announced in the budget as the policy of the

government. The proposals were formulated by a small group of tax specialists within the Department of Finance, with few others in the government and no one outside aware of what was being developed. While there was the usual round of pre-budget consultations, the traditional form of these "discussions" is that the minister and his officials listen to the proposals of the various interest groups, but secrecy prohibits them "from responding in ways that might reveal measures that were under consideration."[12]

The choice of the normal budgetary process to introduce tax reform may have been, in part, a reaction to the 1971 experience. In that case extensive and extended prior discussion and public consultation produced a final tax package that was far from the ideal. Perhaps by short-circuiting that process, the influence of those with special benefits to protect would be reduced. A quick and sudden process might reduce the time and opportunity available to the opponents to mobilize and organize their lobby.

Of course, as is well known, the actual outcome was a disaster for the reform package and for the Minister of Finance. In retrospect, it is difficult to comprehend why a government would undertake a process as potentially contentious as tax reform without prior consultation to gauge the likely public reaction and to attempt to construct a favourable consensus. The opponents of MacEachen's proposals were not at all hampered by the process and were able to mount a massive and unrelenting campaign against them. In the end, almost every proposal, save the marginal rate reductions, was withdrawn or severely watered down.[13] The prestige and power of the Minister and the Department suffered, and ultimately several of its senior officials were replaced.

In retrospect, the 1981 debacle can be explained largely by four factors. The first, already identified, was the failure of the Minister and the Department to consult widely enough to be able to anticipate the reaction they were to face or, preferably, to build a coalition of interests in support of the proposals.

Second, and closely related, there was no constituency of interests that would clearly be winners as a result of the proposed reforms. Tax reform, perhaps to a greater extent than most other areas of public policy, is perceived as a zero-sum game. That is, individuals and interest groups tend to see a fixed sum of money that is to be divided among the government and various groups of taxpayers; what one gains the others must lose. What tends not be to seen is the role of taxation in a dynamic economy. In that context a tax system that is more efficient (or less inefficient) can contribute to economic growth, thereby generating more income and wealth to be shared by government and the private sector.

The MacEachen budget did not succeed in advancing this dynamic view of the tax system to dispel the zero-sum mentality and to identify those who stood to gain from the economic growth that would follow tax reform. In a static framework, the government could not create a constituency of winners largely because approximately half the extra revenues to be generated by the reform were to be kept by government to reduce the deficit. Because the reform was not revenue-neutral but revenue-enhancing, it became difficult, if not impossible, to produce a clear group of winners in the usual static calculus of tax reform. The offer of rate reductions to taxpayers at or near the top of the income

distribution was not sufficient to accomplish this task.[14] As Doern described it at the time:

> The budget purported to tax the rich by closing off the lucrative tax expenditures and distributing the benefits to as many as twelve million Canadians in the form of reduced taxes. The proposal provided for an infinitesimal gain to the members of a dispersed constituency of largely middle class and upper income Canadians. It provided for losses to powerful and cohesive interests.[15]

The third factor in the failure of the 1981 exercise was that inadequate provision was made to deal with transitional problems. "Grandfather" clauses that could have made a bitter pill a bit sweeter for taxpayers without substantially affecting the government's plans were simply omitted. Finally, the overall credibility of the budget was badly damaged because it failed to respond to the serious recession that had already begun by the time the budget was delivered in November 1981. The recession was rapidly becoming the major economic policy concern among the electorate, and a tax reform budget was seen as simply not addressing the right issue. The gross errors in the budget's forecasts of the federal deficit and key economic variables did not contribute to popular feelings of confidence in the Department's competence.

Thus, prior to 1987 there were two serious attempts to reform Canada's tax system. The first, characterized by extensive public consultations through a Royal Commission and a government White Paper, was a very limited success. The second, characterized by budget secrecy and no prior consultation, was a disaster. The common element in these two episodes was the failure of potential winners from the reforms to mobilize to counter pressure by the reforms' opponents.

A Perspective on the Tax System

To structure our understanding of the tax reform process—why it occurs and how it occurs—we must first note the functions that a tax system performs and the types of judgement that are brought to bear in considering each function. We can then discuss tax reform as a process of adjusting the system in terms of its functional orientation. We can consider why these adjustments occur from time to time and the alternative procedures that can be employed to bring them about.

As shown in the preceding description of the history of income taxation in Canada, the tax system serves two general purposes simultaneously. First, and most obviously, it is a mechanism to raise revenues. Put more formally, the tax system is a series of instruments by which control over resources is transferred from the private to the public sector. It is the principal but not the only such mechanism; other instruments include borrowing, the sale of goods and services (user fees), and direct conscription (as in a military draft or the appropriation of land at below-market values).

In this function as a "money machine" a good tax system should meet a number of criteria. While stating them is quite straightforward, achieving them is considerably

more difficult, in part because of differences of opinion as to what a particular criterion means, and in part because of trade-offs among criteria. First of all, from the government's point of view, the system should produce a reliable and predictable flow of revenue. For any given level of economic activity, government officials want to be able to forecast with a high degree of accuracy the amount of revenue that will be generated. Otherwise, they will be forced to contend with a larger (or smaller) deficit than expected, which in turn may lead to unanticipated pressures on government spending and monetary policy.

Second, the ideal tax system is transparent. This means that the tax structure should be simple enough to permit taxpayers (individuals and corporations) to determine readily the tax consequences of any contemplated course of action. It also means that it is desirable to minimize the resource costs of operating the tax system, costs incurred by both the taxpayer and the government. The former are in the form of fees paid to experts and the taxpayer's own time spent complying with the tax system. The latter are the direct collection and auditing costs incurred by the government's collection agency.[16]

Third, and more substantively, the tax system should meet the test of economic efficiency or allocational neutrality. It is desirable that the tax system be designed to minimize excess burdens or distortions in private economic decisions, whether they be investment, labour supply, consumption or saving decisions. For example, this criterion is usually expressed in terms of wanting businesses to make investment decisions based on the inherent economic worthiness of a project, without regard to the tax consequences. Similarly, the argument is made that tax considerations should not affect individuals' decisions about their participation in the labour market; that is, it is desirable to minimize disincentives to work.

Perhaps the most important assumption implicit in these prescriptions is that the economic decisions that taxpayers would make in the absence of any tax distortions are efficient. If so, then the proper role of the tax authorities is simply to find a structure that will generate the desired flow of revenues while leaving these decisions substantially unaffected. This is related to, but much stronger than the transparency criterion. Not only is it desirable for taxpayers to be aware of the tax consequences of their private market decisions, but these decisions must also be unaffected by these tax implications.

Fourth is the major criterion of fairness or equity. This is a difficult criterion by itself because, while there may be social consensus in very broad terms as to what is fair or equitable taxation, defining the concept more precisely can be very contentious. Moreover, when equity and neutrality are both sought, goal conflicts and trade-offs abound.

The notion of equitable taxation encompasses several dimensions and definitional issues. In general terms, the concept of taxation equity seeks to establish a relationship between the economic opportunities of taxpaying units and their tax liabilities. Issues arise with respect to the definitions of both taxpaying units and economic opportunity.

While there continues to be debate over these and similar questions, the issue of equity boils down to comparing the taxes paid by taxpayers with different economic

opportunities and the taxes paid by those with the same economic opportunities. The first dimension, referred to as vertical equity, focuses on the question of whether tax liabilities rise appropriately as taxpayers' incomes rise. Proponents of progressive taxation argue that tax liabilities should increase more than proportionately with income (or with whatever magnitude is accepted as the basis for taxation). Out of this argument come elements of the tax structure such as the progressive personal income tax rate structure, low-income tax exemptions, and perhaps certain tax credit mechanisms (sometimes refundable) targeted to lower-income taxpayers. (These last measures may also be seen in terms of the other function of the tax system, discussed below.) Other versions of vertical equity are also advocated.

The other dimension of equity compares taxpayers who have the same economic opportunity or income (appropriately measured). Equity in this context dictates that they should be treated equally by the tax system. The attainment of horizontal equity, as this concept is known, is closely related to the neutrality of the tax system. Horizontal inequities arise if taxpayers derive their total incomes from different sources in different proportions—for example, wages, interest, dividends, and capital gains—and the effective tax rates on these different types of income differ. If both these conditions are met, then some individuals with the same total incomes will pay different amounts of total tax. On the other hand, if all types of income are taxed at the same effective rate, then horizontal inequities do not arise, irrespective of the composition of total incomes. The second paper in this monograph reports the results of an analysis of horizontal equity in the Canadian tax system.

A tax system that meets these criteria—especially the efficiency and equity prescriptions—is, in a sense, akin to the economist's notion of a public good. An efficient tax system—one that minimizes excess burdens—contributes to overall productiveness and efficiency in the economy. While in theory these benefits can be identified with specific markets and groups, in practice they are widely dispersed across regions, sectors and individuals. Thus the community as a whole has a strong interest in the efficiency of the tax system, even though gains to any particular individual may be small and difficult to identify. Similarly, there is a communal interest in a tax system that adheres to generally accepted broad equity principles. In part, voluntary compliance and self-assessment depend on a general belief in the overall fairness of the system; more fundamentally, society has demonstrated in a variety of ways its commitment to basic equity among its members. Yet, for the great majority of taxpayers, their interest lies in being "free riders". That is, they want these benefits to be realized, but it is not rational for them to devote resources to achieve these outcomes. Ultimately, some form of collective action is required on their behalf.

The second broad purpose of the tax system is to serve as a collection of instruments that can be employed by governments to pursue a wide variety of specific policy objectives. These objectives are both allocational and distributional in nature.[17] The allocational goals include the pursuit of objectives with respect to investment and growth, the structure of the economy, and regional balance. Distributive goals usually include the delivery of benefits to specific demographic groups such as the elderly, disabled persons, and single parents.

A tax or set of taxes gives a government a variety of variables that can be manipulated in pursuit of such policy objectives. These instruments include the design of the tax base, the rate structure, and the employment of tax credits. Together they present policy makers with a rich menu of possibilities for action. It should therefore come as no great surprise that these instruments are used; indeed, as policy instruments they possess some very attractive properties, as noted below.

Among the purposes to which these instruments are directed, some are intended to affect the allocation of resources in the economy, while some are to grant preferential treatment to specific demographic groups believed to be deserving of such assistance. Tax measures used to affect allocation are, of course, in direct conflict with the maxim of tax neutrality; influencing the allocation of resources means introducing deliberate non-neutralities into the tax system. For example, tax measures are often employed to influence the pattern of private economic investment.[18] Special credits and deductions are offered to firms investing in plants and equipment in designated regions of the country. Tax incentives are offered to spur research and development (R&D) in the private sector. Individuals buying shares in Canadian companies are given preferential treatment over those investing abroad. Investment in physical capital is generally encouraged by capital cost allowances that permit firms to depreciate capital for tax purposes more rapidly than the actual rate of economic depletion. Tax instruments are used to encourage exploration for natural resources and development of these resources.

Similarly, tax incentives are offered to individuals to save some of their current income for retirement purposes, to purchase homes, to support charitable activities, to advance the education of themselves and their dependent children, and to support political parties. All these tax expenditures presumably affect the allocation of resources in society compared to what would be the case in their absence. It is important to appreciate that the public policy objectives sought through these measures may all be quite valid and desirable. The point is that, as in many areas of public policy, a conflict arises between competing "desirables".

Tax expenditures are also used to assist individuals experiencing special circumstances. For example, special deductions and credits are offered to the elderly, the handicapped, and those with large medical expenses. These purposes might be viewed as "micro-equity" objectives, as distinct from the general equity objectives discussed above. Again the validity of these objectives is not at issue.

The design of any major tax (and of the tax system as a whole) emerges from attempts to pursue all or many of these public good and specific purpose objectives simultaneously; some of them are compatible, but many are not. It is by deciding where to settle on these numerous trade-offs that the tax structure emerges, that is, by achieving a (temporary) balance between the contending public good benefits and the benefits that preferential tax measures confer on specific groups. The preferential measures usually find advocates within interest groups; these advocates tend to be small in number but their interest in taxation tends to be sharply focused. Given the free rider problem, it falls to government itself to ensure that the public good is provided for the

general benefit of the community. With this in mind, we turn to the questions of tax design and tax reform.

The Tax Reform Cycle

We have seen that the tax system in general and the income tax system in particular serve two broad purposes. This recognition is important to understand the dynamics of tax policy over time. The brief discussion of the history of income taxation in Canada also suggests that tax policy decisions are arrived at through three separate processes. While they are obviously related in the sense that they all concern the same tax system, they are distinguishable in terms of the issues at stake and, at least partially, in terms of the actors involved.

First, there are tax decisions that emerge primarily as a result of federal-provincial fiscal arrangements. In addition to tax harmonization, other arrangements that involve tax measures, such as the Established Programs Financing (EPF) arrangements, fall into this category. The process by which these tax decisions are made primarily involves federal-provincial negotiations, and these two parties are often the only ones involved.

Second, tax changes are made at the margins of the system on a regular basis as part of the normal revenue budget process. These measures tend to be changes in specific instruments focused on specific, quite narrow, objectives. The budget cycle, with the exception of the economically turbulent period in the late 1970s and early 1980s, is an annual one. While the Department of Finance is clearly the focal point of this process, other agencies of government may also contribute or suggest measures, along with the main established interest groups. These are mainly business-oriented organizations, but more recently social policy agencies have also been involved. We return to these interest groups below. The incremental changes that emerge from the regular budgetary cycle have been characterized as the results of anticipatory behaviour; that is, the Department of Finance, in formulating policy, anticipates the reactions of the "tax community."[19]

Third, there are explicit tax reform exercises, the focus of this discussion. Tax reform, like the initial design of a tax system, tends to focus on the first of the two broad functions, namely the public good character of the revenue generating mechanism. Consideration of other goals and the use of tax instruments to achieve these goals are not completely absent, but generally are given less weight. This is certainly true when compared to the situation where tax policy decisions are reached in the context of the budgetary cycle. What we have observed can be described as follows: begin with a tax system that incorporates an acceptable balance between the two broad functions. Over time, this balance is disturbed as more tax expenditures are enacted in pursuit of specific policy objectives and others are enriched. After some period of time, the initial balance in the tax system is disturbed to an extent sufficient to generate effective pressure for its restoration, and a reform exercise occurs to construct a new balance. The restoration may not bring the system back to its initial starting point, however, but to a point deemed

appropriate in terms of the political and economic considerations of the day. Having achieved this reform, the tax cycle begins anew.

One must be circumspect in generalizing from a very limited number of observations. The cycle is not predictable in terms of its regularity; nor are we suggesting that there is some "organic" regulator of the pattern. Rather, the suggestion is that there does appear to be a repeating pattern, and that the time period involved is rather long.

Why does this cycle occur? In other words, what explains the "drift" of the tax structure from an initial balanced position, and what forces are at work to reassert the balance from time to time?

A good deal has been written about why governments enact tax expenditures. One can usefully view this phenomenon in terms of supply and demand relationships. Governments supply tax preferences to special interest groups that demand them and are prepared to make a "payment" in return. Presumably, as in any voluntary transaction, both parties benefit. The benefits to the interests securing the tax expenditure are obvious; they are financial. For example, tax preferences granted to promote investment will increase net rates of return, increase employment and wages, or increase profits. Whether, at the same time, they advance the public goals of stimulating the targeted investment may be a question of some debate. To secure these benefits, the favoured parties make payments to the government of the day. These may be in the form of political support to the party in power, support for other policy initiatives of the government that complement these tax measures, and economic investment in desired regions (possibly specific constituencies) or sectors of the economy.

While it is quite true that these interests seek favourable policies of other varieties as well, tax expenditures are particularly attractive to certain interest groups. First and foremost among these is the fact that tax expenditures are much less visible than corresponding direct expenditure programs. The cost of a tax preference does not appear in the government's annual estimates and is not voted annually by Parliament. The measure need only be written into the tax code once; then it continues indefinitely unless and until Parliament votes another explicit change in the tax structure. In addition, while the Auditor General has begun, in recent years, to discuss tax expenditures in his annual reports,[20] there is no audit of tax spending as there is of direct spending. Partly for these reasons, the allocational and distributional impacts of most tax expenditures are much less well understood than is true of direct spending programs. If the tax expenditure is sufficiently specialized, its very existence may be all but unknown to any but those with a strong financial interest in knowing. There is also a sense in which the business interests that lobby for tax expenditures see them as acts of non-intervention by the government because they view the revenues involved as theirs rather than as the result of preferential departures from the baseline tax system.

Nonetheless, one can still usefully view the government as "selling" tax expenditure benefits to interest groups for a price that is denominated in various types of political and policy support.[21] It is also costly for governments to "produce" these measures and these costs may increase with quantity. The most obvious cost is forgone tax revenue and the consequent adjustments required to extract the missing revenue from this tax or

elsewhere in the revenue system. This may occur in the form of a higher tax rate levied on the same tax affected by the tax expenditure, higher other taxes, or a higher deficit (borrowing). In addition to the forgone revenue cost, each tax expenditure contributes to the complexity of the overall tax system, making it more costly to operate for both the government and taxpayers. Further, tax expenditures damage the integrity of the tax system as a revenue generator by introducing horizontal inequities, often by diluting overall progressivity and, as a consequence of the first two, by creating cynicism and negative political reaction. Witness, for example, the political mileage that opposition parties are able to generate by focusing media attention on individuals with very high incomes and large profitable corporations that pay little or no income tax.

Over time, with the proliferation of tax expenditures, these costs appear to increase, not just in total, but per unit of benefit delivered. There are several reasons for this. Each tax expenditure individually introduces complexity into the tax system, but in addition, the interaction of tax measures makes for further complexity. Thus, complexity may increase more than proportionally with the number of special tax preferences.

The cost to the government also increases more than proportionally with the number of tax expenditures because the predictability of revenue flows diminishes. This, too, appears to be a function of the interaction and complexity of multiple tax expenditures, especially those in the corporate income tax system. Closely related, the probability rises that unforeseen loopholes in the system will generate expensive (in terms of revenue losses) and politically embarrassing costs. Perhaps the most flagrant example in recent years was the ill-fated Scientific Research Tax Credit (SRTC), which drained approximately $3 billion from federal revenues but generated a negligible amount of new research and development activity.[22]

These costs, which are of particular concern to officials in the Department of Finance, in part reflect an opposing demand for a tax system that serves the public good criteria of efficiency, equity, and predictability. Finance officials see their Department as the only agency in Ottawa with a perspective on the total economy. If anyone in Ottawa is responsible for the overall performance of the Canadian economy, it is Finance. As such, its officials are concerned with efficiency in general terms and are less sympathetic to special tax provisions that are intended to create specific desirable "distortions" than are officials in other, more micro-oriented agencies of government. It is from Finance's special perspective that these provisions are seen as damaging the tax system as a predictable source of revenues for government that is, in general terms, efficient and equitable. Tax expenditures diminish confidence and certainty in these instruments, a cost whose realization is almost entirely borne within the Department of Finance.[23]

The cost of impaired ability to forecast revenues is of particular concern within Finance. It is ultimately the Department and the Minister who must bear the discomforts that ensue from errors in forecasting revenues and the fiscal position of the government. Public pressures that develop around large deficits are directed largely to the Minister of Finance. Moreover, it is worth noting that, if these pressures lead to unanticipated expenditure restraining exercises, the Minister of Finance may encounter difficulties with his Cabinet colleagues as well. In addition, a strong, if largely unfocused, political pressure exists for tax fairness, a manifestation of demand for the public good function

noted earlier. Public reaction to stories about high-income individuals paying little or no tax and the appeal of campaigns against "corporate welfare bums" are evidence of this pressure.

In the years following an explicit tax reform exercise, the number and generosity of tax preferences tends to increase and, as we have argued, their cumulative cost increases. It is during this period that tax changes emerge from the regular budget cycle; yet because of the influence of the media and other factors, budgeting has become a process in which tax system design is secondary.[24] The focus of budgetary economic policy tends to be on stabilization, sectoral adjustment, regional growth and equity issues that are often quite specific in nature. Thus, while Finance still controls and writes the budget and, for the most part, measures are announced by the Minister of Finance in his budgets, other departments and interests exert influence on the outcome.[25]

When the cumulative costs of drift in the tax system come to be perceived as unacceptable by Finance, the Department launches a new round of tax reform. Thus the tax cycle is completed. In the reform exercise, the public good principles of the tax system as a revenue generator are reasserted, while the use of tax instruments to pursue specific objectives is de-emphasized. Given the perspective of the Finance Department, this is precisely what one would expect to occur.

In terms of the demand and supply perspective on tax preferences, one can interpret this process as a cancelling of contracts previously struck with special interest groups. Since the contracts and the benefits from them are voided by tax reform, one could also expect interest groups to seek new benefits from preferential tax measures, thus beginning the cycle again. Of course, it is also true that special interest groups will not stand by idly and see their tax benefits eliminated or severely restricted by the reform process. Accordingly, we observe these interests mounting efforts to protect their benefits during the reform exercise itself.

The success of these defensive efforts will depend on a variety of variables. First, the vocabulary of the debates and the roster of participants tend to be different during reform exercises than during other periods. Once the government has embarked explicitly upon a tax reform process, the focus of discussion tends to be on the tax system *per se*, that is, upon the tax system as a mechanism to raise revenues. Therefore the terminology employed directs attention to equity and fairness, economic efficiency, simplicity, and predictability of revenue flows.

In contrast, when tax reform is not on the agenda, discussions of specific tax expenditures use expressions such as investment incentives, regional development, employment creation or protection, and economic security. These latter phrases obviously favour the special interest arguments, while the former group of phrases puts them, in relative terms, at a disadvantage. Reform exercises openly give more consideration and weight to the revenue-raising function of the tax system, while in the intervening periods, policy discussions proceed in terms of the specific concern at hand. The broader goals recede into the background.

Therefore, part of what determines the success of the defenders of special interests in tax reform is how well they are able to express their private interests in terms of the general objectives that tend to be the coinage of the tax reform discussions or, in other terms, how well they are able to address the public good aspect of the tax system.

Another difference between the reform and non-reform periods is the list of participants and the form of discussions. During non-reform periods, when the focus is on specific sectoral issues, the policy formulation process involves consultations with or interventions by the parties directly favoured by the measure(s) under consideration. Often these discussions are held in private, and other departments of government whose mandates involve the policy areas at issue may become involved as well, often as advocates for tax expenditures. The representations reaching the Department of Finance thus tend to favour one side, the side of the (potential) beneficiaries, while the more general interest, the integrity of the tax system as a revenue generator, is given less prominence. This is not to say that the general interest is absent or not represented; this is a continuing concern of the Department of Finance. It is a question of the relative consideration or emphasis given the two facets of the tax system.

In reform exercises, this relative emphasis shifts. More public consultations are held, if not by the Department itself, then by parliamentary committees. Discussion in the media influences the debate. Public discussion is explicitly about the tax system, rather than about how to stimulate research and development activity, how to promote investment in a disadvantaged region, or other such issues. Moreover, groups that may not have participated in discussions about tax expenditures are consulted and do intervene on the question of tax reform.

Finally, the length of the reform process may be a factor in the outcome. The Carter exercise (1971) and the MacEachen attempt (1981) represent the extremes. The first occupied almost a full decade from start to finish, while the latter was launched publicly one evening in a budget speech with little or no advance discussion. A lengthy period with numerous iterations, successive rounds of consultations, and numerous forums for public debate ultimately provides an advantage to those interests with the organization and resources to participate throughout the length of the process. The MacEachen budget, by going to the opposite extreme, ironically encountered the same problem. Because it came so suddenly, it was the interests that maintained continuous lobbying operations that were able to react quickly. Groups and interests that might have been expected to come to the defence of the budget, for the most part, did not have this capacity for quick response; the debate, if it can be called that, was from the outset virtually one-sided.

Tax Reform in 1987

We turn now to the tax reform exercise launched publicly by Finance Minister Michael Wilson with the tabling of a White Paper on June 18, 1987. In this section we discuss the

factors behind this initiative to reform the tax system; in the next we examine the government's goals in the exercise and how it proceeded to attain them.

As a mechanism for generating revenues, the income tax system was, in the eyes of Finance officials, clearly becoming less and less satisfactory. Its failure to meet three major criteria—efficiency, equity, and predictability—was becoming increasingly obvious. Since the reform of 1971, the income tax system, both personal and corporate, had become increasingly cluttered with new tax expenditures and enrichments of existing measures. In terms of the second perspective on taxation policy instruments, each of these measures could be (arguably) justified in terms of one or another specific policy goal. However, their accumulation, and in some instances, their interaction, eroded the integrity of the tax system *per se*. The costs of tax expenditures, in the eyes of the government, had become too great to sustain.

For example, the proliferation of tax preferences, usually in the form of deductions or exemptions from income, narrowed the base of the personal income tax, thereby requiring higher marginal rates than would otherwise be needed to generate any given amount of revenue. These relatively high marginal rates created incentives for individual taxpayers that were inefficient from a social perspective. There was a sense that saving and investment decisions were being made increasingly on the basis of tax advantages rather than market considerations. Tax-induced investment in residential real estate at the expense of investment in income-producing plant and equipment was one example. While these considerations are relevant to only a small segment of the population, the arguments found a receptive audience in the Mulroney government.

Another form of inefficiency arose from the different rates of effective tax that came to be applicable to different forms and sources of income. These differences resulted from such measures as preferential tax treatment of dividends and capital gains, and the assortment of investment tax credits, research and development incentives, and real estate preferences. In terms of efficiency, these measures distorted investment flows. Clearly, that is what they were intended to do, but in terms of the broad view taken by Finance, the distortions were inefficient rather than efficiency enhancing. In terms of equity, the measures also created horizontal inequities.

As the tax system became more complicated, there was also concern over the costs of compliance and tax avoidance activities. While neither of these effects is readily quantifiable, there was a clear perception that costs were growing, in part because the reliance on tax measures as instruments of policy had increased quite dramatically, especially during the 1970s, and in part because of the interaction between various measures. For example, a number of studies and estimates of the size of the underground economy focused on activities that were legal in themselves but were carried out in ways that could be hidden from the tax collector (e.g., cash transactions, barter).[26] Estimates indicated that the underground economy had grown to upward of 5 per cent of GNP. This development was of concern for at least two reasons. First, it was an indicator of increasing costs at the margin of tax compliance or, in more general terms, the cost of running the tax system. Second, it was also an indicator of increasing revenue losses for the federal government (and incidentally for the provinces as well).

Overall, the various aspects of inefficiency can be subsumed under the neutrality criterion. The proliferation of tax expenditures progressively moved the tax system further and further from an acceptable position in terms of neutrality and created an assortment of tax motivations for private economic decisions. These costs came to be recognized increasingly both inside and outside government.

In terms of equity, the main problem perceived by the government concerned horizontal equity. This issue relates closely to efficiency problems in the manner noted previously. Many of the tax preferences created different effective tax regimes for different sources of income. For example, income from capital is generally taxed more favourably than income from labour, and different types of capital income face different tax rates (see the following paper). Taxpayers who derive the same total incomes from these various sources in differing proportions can therefore pay tax bills that are also significantly different—hence, horizontal inequities.

This alternative view of the non-neutrality problem was a concern largely for (small-p) political and ethical reasons. The existence of large horizontal inequities simply violated one's sense of fairness, and that by itself was a major reason to seek correction. In addition, public perceptions of the inequities carried the potential for major political and administrative problems. An income tax system such as Canada's relies to a large extent on voluntary compliance and self-assessment. Without these attributes, collection costs would rise enormously. These attributes, in turn, are in large part dependent upon a public perception that the tax system is basically fair, that every other taxpayer is paying his or her "fair" share. Information and impressions of inequities can thus be destructive of this system of self-assessment. Particularly damaging are stories about high-income individuals who pay no tax at all.

Another factor of considerable concern to Department of Finance officials was declining certainty about the flow of income tax revenues, again as a result of tax expenditure growth in the 1970s. This problem was especially severe with respect to the corporate income tax. The problem had both episodic and systemic dimensions. Perhaps the prime examples of the former were the Scientific Research Tax Credit (SRTC) of the early 1980s and the major revenue loss associated with the Gulf Canada sale in 1985.[27]

The systemic trend to less predictable revenue flows emerged most clearly with the recovery of the economy from the major recession of 1981-82. As corporate profits began to increase, the flow of corporate tax revenues did not increase commensurately as experience might have led one to expect. The reason for the shortfall was the stock of accumulated tax deferrals that corporations were able to use to avoid taxes as their profits recovered. As a result, it became much more difficult to forecast the flow of revenues because of the uncertainty associated with predicting when corporations would decide to use these shelters.

The revenue problem became more prominent after the election of the Mulroney government in 1984. The government in general, and the Minister of Finance in particular, took deficit reduction to be one of its primary duties. While most of the

government's rhetoric and visible policy moves were directed to restraining expenditures, the lagging revenues did not escape notice within the Department of Finance.

Still another factor that became prominent at about the same time was the income tax reform exercise in the United States, which became effective in 1986.[28] The U.S. reform was influential for two reasons. The first was that the new American income tax system, with its significantly lower rates, created an impression that the Canadian tax system was suddenly much out of line with that of our largest international economic partner. Expressed somewhat differently, the cost of continuing the existing array of Canadian tax expenditures suddenly increased. This created pressure on the government to adjust the Canadian system to avert the possibility of large-scale capital flows to the United States in response to the newly created tax differentials. Some members of the government also held the view that the lower U.S. personal income tax rates created a similar risk of a major outflow of skilled professionals from Canada.[29]

In addition to its substantive influence, the American exercise was important simply because it occurred and was generally politically popular. As noted earlier in our brief review of the history of efforts to change the tax system, tax reform in Canada had been a highly risky business in political terms. The American experience served as a counter to that history (and especially to the political disaster of 1981); it held the promise that a well orchestrated reform process could not only lead to a successful outcome, but could be of political advantage to the government as well. Moreover, the general perception that the U.S. moves necessitated corresponding action by Canada gave the Minister of Finance a window of opportunity to push through a tax reform package in relatively short order. While the other factors discussed in this section were also important to the emergence of tax reform as a public policy issue, there is little doubt that the U.S. reform served as an important catalyst with respect to the timing of its emergence.

Finally, the apparent need to reform the federal sales tax, which had long been a concern of the Finance Department, became increasingly prominent, partly because of the prospect of free trade. The tax was far from neutral, altering relative prices to favour imports over domestically produced substitutes, and was probably the most regressive tax levied at the federal level. These anachronisms and inefficiencies in the sales tax, which had long existed, were becoming more important as the government relied on this tax to generate more of its revenues. Finance Department officials had been working on sales tax reform plans for some time, and this work was an additional factor generating an initiative for general tax reform.

The convergence of all these factors, along with the general thrust of the Tory agenda (addressed below) placed tax reform on the public policy agenda. With his first economic statement in November 1984, and in each of his subsequent budgets, Finance Minister Michael Wilson began to set the stage for the White Paper of June 1987. We turn now to a discussion of the reform package, the government's objectives in entering the process, and the process itself.

Tax Reform and the Tory Agenda

The Mulroney government elected in September 1984, despite many initial impressions to the contrary, had a clear domestic agenda. Its goal was to diminish the role of the state and the amount of government intervention in the Canadian economy and, correspondingly, to strengthen the forces of the market. In part, these objectives were quite straightforward expressions of the philosophy of many members of the Progressive Conservative caucus and Cabinet. In part, they were spillovers from the Reagan presidency and, perhaps even more strongly, from the Thatcher government in Great Britain. These governments provided models to follow, but in addition, they were taken to be evidence of a new public receptiveness to conservative ideology.

Certainly not all members of the Mulroney government subscribed to this new agenda with equal enthusiasm and vigour. Some, for example, were much less inclined than others to tamper with the components of the social welfare system. The Prime Minister himself was clearly not as ideologically committed to the cause as was, say, Mrs. Thatcher, and perhaps as a consequence his government has proved less consistent in pursuit of these objectives.

Nonetheless, a discernible theme runs through the government's domestic policy, and tax reform fits well into it. A sketch of the main elements of this theme will provide the necessary context. The first major initiative in this direction was expenditure restraint—the move to limit the growth of government spending and actually to reduce spending wherever possible. Government spending is the most visible form of state intervention, and it therefore should not be surprising to find it as an early target. At times expenditure restraint was justified directly in terms of the need to remove government from areas better left to the private sector. More often it was expressed in terms of the need to reduce the budget deficit. But it is revealing that the deficit reduction argument was almost invariably advanced in terms of expenditure reductions and never in terms of revenue enhancement.

An important component of expenditure restraint, and one related to tax reform, were moves to alter or limit social security spending. At one time or another, the government gave serious consideration to changes in Old Age Security payments, the Unemployment Insurance system, and Family Allowance payments. While actual changes were implemented only in the Family Allowance program during the 1984-88 mandate, there is little doubt that the government was concerned, in a time of overall expenditure restraint, with the amount of resources being devoted to social programs. A link between these programs and tax reform exists because the tax system plays an important role in adjusting the net benefits that individuals and families receive from these programs and in delivering social programs more generally. Given the government's very limited success in modifying direct social spending, tax reform was seen as an opportunity to address social policy from another direction and to create some flexibility for the future. Once the personal income tax system was cleaned up, the stage would be set to address the social welfare system as a whole, using the less encumbered tax structure to carry a major part of the burden of these adjustments.

Another element of the government's conservative agenda during that period, and one that also has links to tax reform, was the pursuit of a free trade agreement with the United States. This agreement, then being negotiated, will clearly make the functioning of the Canadian economy more subject to market forces, in this case North American market forces. Further, it will restrict the scope available to this and future governments to intervene in the economy as long as the agreement is in force. While this latter effect may not have been the primary objective of the free trade initiative, it is consistent with the objectives of ensuring access to larger markets and promoting entrepreneurship and innovation.

The trade agreement could be expected to make the close links between the Canadian and American economies even closer. That prospect, in combination with U.S. tax reform, provided an additional impetus for the Canadian reform. The argument that the Canadian tax system could not be allowed to fall seriously out of line with the U.S. system was strengthened by the prospect of free trade.

Other notable elements of the government's agenda include privatization and deregulation. The sale of commercial Crown corporations turns enterprises over to private operators who, it is believed, can operate them more efficiently and profitably; at the same time, government withdraws further from active participation in the marketplace. Deregulation is also part of the overall strategy; it repeals legislated rules adopted originally to influence the market responses of firms in certain industries.

These policies, which were intended to promote the general goals of the government, were not always pursued aggressively or successfully. First of all, in public policy, the exigencies of the short term always interfere with the goals of the long term. For example, low grain prices and political pressure combined to produce a major grant program for Western farmers at the same time the government was attempting to reduce spending and the deficit. Similar stories could be told about energy expenditures and taxes, the de-indexation of pensions, several other expenditure measures, and privatization. However, the success or failure of the government in these areas is not the focus of this discussion. Rather, the point is that there is a consistent philosophy underlying much of what has been attempted.

Tax reform clearly fits into this agenda. The White Paper unveiled in June 1987 and the legislation passed in 1988, which implemented the first phase of the reform plan, propose a tax system that is less interventionist than the one it replaces. It is less active in using tax incentives to stimulate and direct the flow of investment by industrial sector, by region, and by economic activity.

In terms of the criteria enunciated in the second section of this paper, the guiding principle of this reform is economic neutrality. The goal is to remove the tax system as a significant factor influencing private sector decisions. This theme is echoed repeatedly in the Finance Department's discussion of the personal and corporate income tax. For example, the White Paper states that "[a]s a general principle, the government should refrain from using the tax system to subsidize particular types of investment activity."[30] In its discussion of the corporate income tax, the White Paper states that "[r]eform measures encourage investment through lower tax rates instead of through selective

write-offs. As a result, investment decisions will be based more on the underlying profitability of investments and less on tax considerations."[31] As for the proposed new sales tax, the 1987 White Paper argued that it "provides no incentives to businesses to alter their production or distribution systems nor does it affect their competitive positions in the market."[32] The last point would be achieved largely by removing the advantage given imports over domestic products under the current federal sales tax.

The government's movement in the direction of allocational neutrality is by no means total. Many measures remain in the personal income tax that are intended to influence economic behaviour. For example, the large incentive intended to stimulate retirement saving remains. The move from deductions to credits changes the form of several other incentives, but again does not remove them from the system. With respect to the corporate tax, it is noteworthy that the generous subsidies to R&D remain largely intact. Yet, it is still the case that the revised tax system will have less influence on private economic decision making than the old system did.

The other major design criterion, equity, is addressed but is accorded less weight. There is a clear recognition that the current personal income tax is horizontally inequitable, because this dimension of equity is closely related to certain non-neutralities in the tax system.

In terms of vertical equity, three major components of the reform are relevant. The measures to broaden the tax base, such as the elimination of the investment income deduction and the reduction of the capital gains exemption, contribute to improving horizontal equity and to making the income tax more progressive. The changing of exemptions and deductions to tax credits is also a move towards increased progressivity. Finally the restructuring of the tax rate brackets counters the first two elements in that it reduces the progressivity of the system.[33]

The change in the rate structure appears to be a response to two related factors. First, it follows the pattern set by the American tax reform; we have already discussed why the government felt constrained to depart only marginally from the U.S. tax structure. Secondly, in recent years the idea of a flat-rate income tax had become part of the catechism of neo-conservatives, influencing sympathetic decision makers in both Washington and Ottawa.

With respect to the criterion of transparency or simplicity, the tax reform does not appear to have made much progress. Changing deductions and exemptions to tax credits is a move towards progressivity, but it does little if anything to simplify the system. Reducing ten tax brackets to three also accomplishes little in this regard, because the vast majority of taxpayers compute their taxes from published schedules in any event. Moreover, as the following paper demonstrates, the determination of effective marginal tax rates involves complex interactions between various tax provisions and transfer programs.

This tax reform exercise, like the others discussed, can be seen as completing a tax cycle. It seeks to shift the thrust of the system in order to place less emphasis on taxation as a set of policy instruments and more on the design of a good revenue generator. Within

the latter framework, reformers can choose to emphasize different design criteria (e.g., efficiency, equity), and to select different trade-off points where these criteria conflict with one another. The Carter Commission (and the MacEachen budget) chose to emphasize equity and tended to treat the economic neutrality criterion as a constraint. The Wilson tax reform of 1987-88 emphasizes efficiency or allocational neutrality. It recognizes the equity criterion (both its realization and the perception of its realization) but does not accord it the same prominence as the Carter Commission did.

The process adopted by the government to achieve its tax reform objectives followed a different path than either the Carter process or the MacEachen budget. The government was not interested in embarking upon the long slow process entailed by a Royal Commission or some comparable approach. Neither was it about to take the risk that led to the 1981 debacle, an announcement in a budget with no prior warning or consultation. The route chosen was for the government, and the Minister and Department of Finance in particular, to develop the tax reform plan and at the same time to indicate clearly and publicly the general thrust of the planned reforms.

The process started early. Although it may not have been deliberate, some aspects of the reform themes were already apparent in the Minister's first economic statement (mini-budget) in November 1984. In that speech, Mr. Wilson spoke of the need for less reliance on government and of the intended move to greater reliance on the signals of the marketplace.[34] Further, he identified the concern about high-income individuals paying little or no tax and expressed a general concern that the tax system was neither efficient nor fair.[35]

Wilson's first formal budget was presented in May 1985. In it he echoed the theme of greater reliance on market incentives. Although he rejected the idea of full-blown tax reform,[36] he did table a discussion paper on the topic of a minimum personal income tax and another on corporate tax reform.[37] The latter paper, which proposed fewer tax expenditures and lower tax rates, established the framework that was followed in the subsequent reform of the corporate tax.[38]

The next budget, delivered in February 1986, actually began the process of corporate tax reform. The inventory allowance and the general investment credit were eliminated, and a phased reduction of corporate tax rates was announced.[39] The point was also clearly made that these measures were to be viewed as the first phase of a reform program, and the thrust of the future reform measures was established. In that budget, the Minister also announced that work was under way on the reform of the federal sales tax.

In October 1986, Mr. Wilson set forth the principles of what had now become a tax reform exercise involving the personal income tax as well as the other two taxes that had been discussed.[40] The guidelines were consistent with the themes the Minister had expressed earlier. In general, taxes were to be simplified, special provisions were to be removed or limited, thereby broadening the bases, and tax rates were to be reduced. The "Guidelines" paper invited comments from the public and promised that tax reform would be a major topic in the Minister's upcoming round of pre-budget consultations. Finally, in

the budget of February 1987, Mr. Wilson stated briefly but quite explicitly the broad outlines of the forthcoming tax reform proposals.[41]

In addition to these formal parliamentary occasions, the Minister and Department of Finance officials were actively engaged in other forms of notification and consultation. There were, for example, speeches and public statements, the pre-budget consultations, and other consultations explicitly on tax reform. A series of meetings was held with the provinces, at both the ministerial and the officials level. Thus, by the time the White Paper was released on June 18, 1987, the government had laid extensive groundwork for its proposals. It had clearly signalled its intentions, so the White Paper contained no real surprises for anyone who had been following the earlier pronouncements. This process of consultation and consensus building was certainly one of the principal reasons the Wilson income tax reforms encountered relatively smooth sailing, especially by comparison with earlier reform exercises.

Perhaps the Minister and his Department have struck a judicious balance between consensus building in advance of a policy announcement and leading with policy in advance of consensus. The tradition of secrecy surrounding tax policy making has always made the latter route a risky one. The 1981 experience provided clear evidence and a constant reminder of this risk. This time the government attempted to move towards consensus by signalling its aims and intentions, while attempting to maintain secrecy with respect to specifics.

In addition, the lack of significant opposition to the Phase I reforms was attributable partly to the relative moderation of the reform package and the deferral of its most contentious elements. Superficially, the Wilson reforms may have appeared to be on a scale with the Carter Commission report and much more fundamental than the MacEachen proposals, which dealt only with the personal income tax. In actuality, however, the Wilson proposals were more moderate than either of their predecessors in terms of depth. In the personal income tax, for example, few tax expenditures were eliminated outright; most of those that were addressed were modified, as in the shift from deductions and exemptions to credits. While these modifications are meaningful, they generated less opposition than their elimination would have. In the case of corporate tax reform, the process was well launched prior to June 1987, so that the White Paper represented a continuation rather than a new departure.

Finally, it should be noted that because the reform is revenue-neutral, at least in its early years, the government has more scope to balance losses against gains. In this respect, it is quite different from 1981 when the government of the day attempted to realize half the revenue from the tax expenditure cuts and to return only half to taxpayers in the form of reduced rates. This exercise gives the government the resources to offer more meaningful rate reductions, thereby creating clear gains for certain groups of taxpayers.[42]

Conclusion

The tension between designing the tax system to raise revenues efficiently and equitably, on the one hand, and using tax instruments to pursue other specific policy goals, on the other, is continuous. A wide range of voices is constantly present to argue for special tax preferences, whether they be to stimulate investment of one particular type or another, to assist specific deserving groups, or to serve some other relatively narrow goal. Other, newer voices, largely from the social policy community, provide some counterweight but also create different pressures for special treatment. Against this array, the only permanent institutionally based voice concerned with the public good aspects of the tax system as a revenue generator and the balance between the two broad functions comes from the Department of Finance itself.

When tax policy making is confined to the normal budgetary process, it should not be surprising that the tax system tends to drift towards its special purpose function at the expense of its revenue raising role. Over time, more and more special provisions are written into the tax laws; as a result, the system becomes less and less satisfactory in terms of its revenue raising function. When the balance between the two is sufficiently disturbed, or in other words—when the cost of supplying the special preferences becomes too high—the tax system is reformed and an acceptable balance between the two functions is reasserted, if only temporarily.

If this balance could be better maintained on a continuing basis, perhaps public policy in general would be better served. Major reform episodes, such as the three examined in this paper, create uncertainties and may involve large transitional costs that disrupt the economy, no matter how beneficial the final outcome. These costs could be reduced if the voices in support of the broad goals of efficiency, equity, and simplicity in the tax system were strengthened permanently.

One way to accomplish this would be to rely on the recently strengthened Commons committee system. In 1987 (and in earlier cases as well) the House of Commons Finance and Economic Affairs Committee did hold hearings and issued a report on the White Paper. However, the Committee's mandate encompasses many issues in addition to taxation, raising the question of whether it could develop the expertise or capacity to monitor the tax system continuously and effectively.

An alternative would be to create a permanent new organization or to add to the responsibilities of an existing policy research body. The new unit (or sub-unit) might be referred to as the Tax Reform Commission.[43] The mandate of the Commission could be to conduct analyses of the tax system and its components, to analyze new tax proposals, and to recommend changes designed to ensure that the tax system serves the general economic and social interests of Canada. Rather than following a cyclical pattern, tax reform could become a more continuous and gradual process in response to changing circumstances. This transformation would mean that tax reform would no longer be a major episodic event and would therefore be less disruptive and less contentious and would create less uncertainty.

The Commission could also be charged with analyzing proposals for new tax expenditures and evaluating existing measures on a rotating basis. These investigations could address the questions of whether a tax expenditure was achieving its intended purposes, and at what cost in terms of forgone revenues, and its cost in terms of eroding the basic functions of the tax system. Ultimately, decisions on whether these costs are acceptable must rest with the government and with Parliament. The role of the Commission would be to provide information and analysis to inform those decisions. This role could be played by the Department of Finance itself. Certainly it possesses the analytical expertise required and has a direct interest in the issues. The advantage of a separate commission would be to establish an additional public voice to speak for the public good aspects of the tax system without the secrecy requirements that constrain the Department.

It is important to be clear about what this Commission should and should not do. It should not become the new locus for tax policy making. That responsibility must remain with the government, specifically with the Department of Finance. The work of the Commission could provide the basis for an additional and important voice in support of the integrity of the tax system. Its authority, which would be moral rather than legislative, would emerge from its expertise and by virtue of the fact that it was not serving the interests of any special interest group. At best, the Commission, through general education activities and through its role of providing information and analysis to Parliament, would alter the nature and tone of public debates over tax policy. Interest groups would be placed in the position of having to respond to concerns identified by the Commission; as a result they would be subject to a form of public scrutiny that, for the most part, does not now exist. They could no longer be as cavalier as many have been in the past in linking their private interests with the larger public interest.

In general, we should be cautious about establishing extra-parliamentary bodies with the potential to impinge on the policy-making roles of government and Parliament. What justifies the creation of such an institution in this case is the role it could fill in supplying the public good attribute of a well functioning tax system. The problem for the policy process, as in the case of most public goods, is to establish a collective institutional mechanism to ensure the provision of the public good. The potential of a Tax Reform Commission should be seen in this context.

Notes

1. For a full discussion, see W.I. Gillespie, "The Birth, Growth and Death of Taxes: Financing the Canadian Federation—The First One Hundred Years", Carleton University, mimeo, 1985.

2. Gillespie, *ibid.* and Stanley L. Winer and Walter Hettich, "The Evolution of Revenue Systems: A Theoretical and Empirical Investigation", Carleton Economic Papers, May 1987.

3. For a full discussion of the emergence of the tax collection agreements and the related recommendations of the Rowell-Sirois Report, see R.B. Bryce, *Maturing in*

Hard Times (Toronto: The Institute of Public Administration of Canada, 1986), Chapters 10-12.

4. For more detail and background on the Carter report, see Royal Commission on Taxation, *Report* (Ottawa: Queen's Printer, 1966); an issue of the *National Tax Journal*, March 1969; and a special supplement to the *Canadian Journal of Economics*, Supplement no. 1, February 1968.

5. M.W. Bucovetsky, "The Mining Industry and the Great Tax Reform Debate", in P. Pross, ed., *Pressure Group Behaviour in Canadian Politics* (Toronto: University of Toronto Press, 1975).

6. M.W. Bucovetsky and R. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal*, volume 25, no. 1 (March 1972).

7. Bucovetsky, *op. cit.*

8. "Report on the White Paper Proposals for Tax Reform", Standing Senate Committee on Banking, Trade and Commerce (Ottawa: Queen's Printer, 1970), p. 39.

9. Bucovetsky, *op. cit.*, p. 103.

10. See D.A. Wolfe, "The Politics of the Deficit", in G.B. Doern, ed., *The Politics of Economic Policy* (Toronto: University of Toronto Press for the Royal Commission on the Economic Union and Development Prospects for Canada, 1985). The introduction of indexing in 1974 is a good example of a major change in tax structure that did not emerge as a result of an explicit tax reform exercise. Indexing was introduced as one item in a regular budget; yet it had a major impact on government revenues over the succeeding years.

11. See A.M. Maslove, M.J. Prince and G.B. Doern, *Federal and Provincial Budgeting* (Toronto: University of Toronto Press for the Royal Commission on the Economic Union and Development Prospects for Canada, 1986), Chapter 5.

12. *Ibid*, p. 77.

13. W.I. Gillespie, "The 1981 Federal Budget: Muddling Through or Purposeful Tax Reform?", *Canadian Tax Journal*, volume 31, no. 6 (Nov.-Dec. 1983).

14. One might well ask why the prospect of deficit reduction did not bring more people to the defence of MacEachen's budget. One possible answer is that reducing the deficit by increasing revenues would not satisfy most proponents of deficit reduction because what they were really seeking was a cutback in government spending. See Allan M. Maslove, "The Public Pursuit of Private Interests", in Allan M. Maslove, ed., *How Ottawa Spends 1985: Sharing the Pie* (Toronto: Methuen, 1985).

15. G.B. Doern, "Liberal Priorities 1982: The Limits of Scheming Virtuously", in G.B. Doern, ed., *How Ottawa Spends Your Tax Dollars 1982* (Toronto: Lorimer, 1982).

16. Another cost of collection that governments seek to minimize is the political cost they incur when the auditing of tax returns comes to be perceived (partly through the media) as excessively zealous or intrusive. While this is not a resource cost like the others, it is certainly of concern to governments, and it is a cost that is directly related to the complexity of the tax system.

17. The tax system is also employed in the pursuit of macroeconomic stabilization objectives. However, one might argue that this goal involves the level of tax revenues rather than the tax structure. While this categorization is an over-simplification, in this paper we will ignore the use of taxation as an instrument of fiscal policy and focus on the allocational and distributional aspects of tax structure.

18. Tax measures such as those cited in these examples are often referred to as tax expenditures, a phrase coined by Stanley Surrey. See his book *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973). Popular discussions and the media often use the more emotive term "tax loopholes", but this phrase is not really appropriate in that it carries the implication of taxpayers taking advantage of the tax system in ways that were unintended by the drafters of the tax code, if not actually illegal.

19. David A. Good, *The Politics of Anticipation* (Ottawa: Carleton University School of Public Administration, 1980). For a more recent discussion, see also Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada: A Public Choice-Rent-Seeking Perspective (Toronto: Canadian Tax Foundation, 1988), Chapter 4.*

20. See the *Report of the Auditor General of Canada* for the fiscal years ended March 31, 1984, 1985 and 1986.

21. The enrichment of the refundable child tax credit and the new sales tax credit does not fit as well into the supply-demand approach as the typical business-oriented tax expenditures. However, it is worth noting that these "social" tax expenditures emerged at a time when the organized voices of the social policy community were growing.

22. Linda McQuaig, *Behind Closed Doors* (Markham: Viking, 1987).

23. Hartle, *op. cit.*

24. Maslove, Prince, and Doern, *op. cit.*

25. Two fairly recent budgets constitute extreme examples of these external influences. The budget of October 1980 was essentially written by a small group in the Department of Energy, Mines and Resources and the Prime Minister's Office. It introduced the National Energy Program and included tax changes in support of that program. In June 1982, the "6 & 5" anti-inflation budget was written with a great deal of input from the Cabinet and government agencies other than Finance. While these examples are extreme cases, they illustrate how the regular budget cycle is typically concerned with non-tax issues, and tax system design is subordinated to these concerns.

26. M. Ethier, "The Underground Economy: A Review of the Economic Literature and New Estimates for Canada", in F. Vaillancourt, ed., *Income Distribution and Economic Security in Canada* (Toronto: University of Toronto Press for the Royal Commission on the Economic Union and Development Prospects for Canada, 1985).

27. For a provocative account of these episodes, see Linda McQuaig, *op. cit.*, Chapters 9 and 10.

28. The government was also influenced by the earlier tax reform in the United Kingdom which was characterized by some broadening of the income tax base and a substantial shift away from income taxes in favour of indirect taxes. Personal tax

rates were cut, especially for high-income taxpayers, and the corporate tax rate was reduced in stages by a significant amount. See R.P. Hagermann, B.R. Jones, and R.B. Montador, "Tax Reform in OECD Countries: Economic Rationale and Consequences", OECD, Department of Economics and Statistics, Working Papers, no. 40, August 1987.

29. It is unlikely that the two risks were comparable, however. Capital markets are very open, especially between Canada and the United States; therefore, tax-induced differences in rates of return might very well stimulate new patterns of investment to the detriment of Canada. Both Canadian and American investors would suddenly find the U.S. relatively more attractive. However, individuals are much less mobile, being motivated by other factors in addition to economic returns, and the extent to which the tax system would induce a flow of migration from Canada to the United States is much less. Nevertheless, the U.S. tax reform was an important influence on both these counts, in part because the Conservative government was more open to the arguments of individuals for whom these differentials were relevant considerations.

30. Canada, Minister of Finance, "The White Paper on Tax Reform 1987", Ottawa, June 18, 1987, p. 4.

31. *Ibid.*, p. 55.

32. *Ibid.*, p. 60.

33. See the following paper for a discussion of the distributional and revenue impacts of the three components of the tax reform. See also Thomas J. Courchene, "Tax Reform: The Impact on Individuals", in E.A. Carmichael, ed., *Tax Reform: Perspectives on the White Paper* (Toronto: C.D. Howe Institute, 1988). Courchene demonstrates that the operation of the refundable credits in fact means that effectively there are more than three brackets and that the rate structure is not nearly as simple as the White Paper makes it appear.

34. Canada, Minister of Finance, "Economic and Fiscal Statement", Ottawa, November 8, 1984, p. 2.

35. *Ibid.*, p. 12.

36. Canada, Minister of Finance, "Budget Speech", Ottawa, May 23, 1985, p. 15.

37. "A Minimum Tax for Canada" and "The Corporate Tax System: A Direction for Change."

38. Lest one get the impression of a single-minded push for tax reform, it is also worth noting that this budget contained a number of new tax expenditures, the most newsworthy of which was the creation of a $500,000 lifetime capital gains exemption.

39. Canada, Minister of Finance, "Budget Speech", February 26, 1986, p. 12-13.

40. Canada, Minister of Finance, "Guidelines for Tax Reform in Canada", Ottawa, October 1986.

41. Canada, Minister of Finance, "Budget Speech", Ottawa, February 18, 1987, p. 11-13.

42. See the following paper in this monograph.

43. Proposals for a Tax Reform Commission or similar body have been advanced before. In 1972, following the Carter exercise, Bucovetsky and Bird, *op. cit.*, suggested that a strengthened Commons committee with a professional research staff would contribute positively to the course of tax system design. In some ways, a Canadian Tax Reform Commission, such as that suggested here, would be comparable to the Joint Committee on Taxation of the U.S. Congress. That body, which employs a permanent professional staff, performs a research function for both houses of Congress.

II

The Distributional Impacts of Personal Income Tax Reform, 1984 to 1988

Introduction

This paper presents a quantitative analysis of the major tax reform proposals in the June 1987 White Paper and compares the post-reform personal income tax system to the system in place in 1984 and to the system that would have been in place in 1988 without tax reform. The former comparison involves analyzing the impact of major changes (such as partial de-indexing) in the income tax system between 1984 and 1988. The main focus of the analysis is the estimation of gains and losses in disposable income experienced by families at different levels of income as a result of the personal income tax changes. Also included in the paper are estimates of the effects of the reforms on horizontal equity and changes in marginal tax rates. Corporate and sales tax changes are not included in the analysis.

Before discussing the substantive results of the analysis, it is important to understand the method by which the results have been obtained. The analysis is based on a new experimental database and computer model developed by Statistics Canada, called the Social Policy Simulation Database/Model (SPSD/M). The database contains information on a representative sample of more than 100,000 individuals living in more than 40,000 households. The associated computer model is able to simulate, for each individual and family in the database, the income tax calculations under a variety of policy scenarios.[1]

The simulation is a mechanical accounting exercise. It assumes that the only impact of a change in tax policy is a change in the tax return form. Taxpayers are not assumed to change their behaviour in any way in response to the policy changes. While such a static modelling approach is undoubtedly incomplete, it does give a good sense of

the first-round impact of the policy changes. The same modelling approach is used by the federal Department of Finance, for example, and by various U.S. agencies involved in the recent American tax reform.

Tax reform was implemented for the 1988 taxation year. However, various participants in the debate on tax reform have tended to make two quite different kinds of comparisons in assessing the reform proposals. Some have focused on comparing the 1988 post-reform situation with what tax policy would have been in 1988 without the reforms. Others have compared 1988 after reform with the situation in 1984 when the Conservative government came to power.

This analysis addresses both perspectives by simulating all three scenarios. All simulations are based on a sample of Canadian households for 1984. All dollar values are at 1984 levels. For example, simulations for 1988 are based on tax parameters that have been adjusted to 1984 dollar values using the Consumer Price Index. Using this common population and income base, tax burdens are estimated for the income tax system as it existed in 1984 (referred to as 1984 status quo or SQ84), as it would have existed in 1988 without the tax reform (referred to as 1988 status quo or SQ88), and as it would exist in 1988 with all the reform measures fully implemented (referred to as 1988 post-reform or PR88). Thus it is possible to offer comparisons between tax burdens in SQ88 and SQ84, between PR88 and SQ88, and between PR88 and SQ84. Through these successive comparisons we can track the aggregate fiscal impacts and the distributional changes from 1984 to full implementation of the reforms. Conducting the analysis over this time period enables us to offer results relevant to the current policy debates over the level and distribution of tax burdens. Changes in provincial personal income tax liabilities are included in the results under the assumption the provincial governments do not adjust their tax rates in response to the federal changes. Sales tax and corporate income tax changes that have occurred since 1984 are not included in this analysis.

The results presented in this paper refer to the changes in the personal income tax system that were announced in the White Paper of June 1987 and the subsequent alterations announced in December of that year. The paper examines the distributional impacts on the total population and on selected family types. It analyzes the impacts of the total reform package as well as its major components. The latter analysis enables us to explain the overall results more clearly and with more precision. The paper also addresses the issue of horizontal equity by examining the dispersion of average tax rates within income classes. Finally, the paper examines changes in marginal tax rates facing taxpayers at various income levels and with incomes derived from various sources. Marginal tax rates relate directly to the question of economic incentives, which was another major concern of the tax reform exercise.

The changes in the tax structure between SQ84, SQ88, and PR88 are outlined in Table 2.1, which describes the tax policy changes involved in moving through these scenarios. As noted in the Introduction, the 1988 personal income tax reform consists of three main groups of proposals—broadening the base of the income tax, converting personal and other exemptions and deductions to tax credits, and changing the tax rate structure. It should be noted that the analysis does not cover all the changes, though it does cover a very large portion, including all of the major changes.

Table 2.1
Summary of Tax Policy Changes

1. **1984 Law to 1988 Status Quo**
   - CPI-3 partial de-indexing of exemptions, tax brackets, and Family Allowance
   - abolition of $200 basic federal tax cut[1]
   - retargeting of child tax credit
   - introduction of $50 refundable sales tax credit
   - introduction of $500,000 lifetime capital gains exemption
   - reduction in dividend gross up and tax credit
   - introduction of alternate minimum tax
   - introduction of 3 per cent surtax

2. **1988 Status Quo to 1988 Reform (as per June 1987 White Paper)**

   A. *Base Broadening*
   - cut in lifetime capital gains exemption to $100,000 and increase in inclusion rate from 50 per cent to 75 per cent (in 1990)
   - further reduction in dividend gross up and tax credit
   - abolition of $1,000 investment income deduction
   - abolition of $500 standard employment expense deduction
   - tightening of auto, business meal and home office expenses
   - * restriction of write-offs on films, MURBs, and earned depletion
   - * slower phase-in of enlarged RRSP contribution limits[2]
   - * abolition of forward and block averaging

   B. *Rate Restructuring and Tax Credits*
   - collapse 10 tax brackets to three and lower marginal tax rates
   - enrich refundable sales tax credit

   C. *Conversion to Tax Credits*
   - personal exemptions (basic, spousal, children, aged, disability)
   - itemized deductions (charity, medical expenses)
   - payroll tax deductions (Canada/Quebec Pension Plans, unemployment insurance)
   - education deductions (tuition fees, monthly amount)

3. **December 1987 Amendments**
   - increase refundable child tax credit by $35 per year
   - increase non-refundable child tax credit for third and subsequent children

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* Not included in simulation.

1. This change was actually introduced in the 1983 budget. It began with the phasing out of the tax reduction for higher-income individuals in 1984 ($256 million initial revenue impact in 1984) and for all taxpayers beginning in 1985.

2. The slower phase-in of the higher RRSP contribution limits was estimated to have an annual impact of $200 million. It is the only item excluded from the analysis with a significant revenue impact. However, the exclusion of this item does not distort the results because the impacts of the higher contribution limits are also excluded.

Fiscal Impacts

Table 2.2 presents a summary of the aggregate fiscal impacts of the tax policy changes as estimated by the SPSD/M. It should be recalled that the 1988 pre- and post-reform scenarios (SQ88 and PR88) have been estimated *as if* all the tax policies were in place in 1984. All dollar amounts are in 1984 values, and economic changes from 1984 to 1988 have been ignored. As a result, total incomes remain the same in all three scenarios, save for small changes in some transfer payments as a result of partial de-indexing in 1985 (Family Allowance) and other adjustments. In effect, the analysis abstracts from economic growth; it shows the "pure" effects of tax policy changes without the influences of changes in parameters such as employment and wages.

Between SQ84 and SQ88 federal (and provincial) income tax revenues increase substantially ($5.7 and $2.1 billion respectively), purely as a result of the changes outlined in Table 2.1 (i.e., in the absence of any economic growth or decline). These income tax increases, along with smaller changes in UI and CPP/QPP premiums, result in an aggregate decline in disposable incomes of $7.9 billion, or 3.2% of the 1984 level. As Table 2.1 notes, one of the major items included in this period was actually introduced prior to 1984. In moving from SQ88 to PR88, federal and provincial revenues decline by approximately half their earlier increase. The net change when comparing PR88 to SQ84 is an increase in tax revenues matched by a corresponding decline in disposable income of $4.3 billion. This amounts to a 1.8% overall reduction in disposable household income.

General Distributional Impacts

Table 2.3 presents an overall picture of the distribution of tax burdens for each of the three tax policy scenarios. Between SQ84 and SQ88 overall disposable incomes decrease by an average of 2.7%. With the 1988 post-reform system, tax cuts increase overall disposable incomes by about 1.2%, leaving overall average disposable incomes 1.4% lower than they were in SQ84. In absolute terms, family disposable incomes fall by an average of $790 between SQ84 and SQ88 and then rise by an average of $360 with reform.

Within this general pattern, average effective tax rates[2] decrease (and hence disposable incomes increase) for the lowest 10% of family units between SQ84 and SQ88 and for the lowest 20% between SQ84 and PR88. The highest income 1% of families experience a tax increase between SQ84 and SQ88, but an even larger decrease in moving to PR88. For all income groups, average tax rates increase when moving from SQ84 to SQ88 and then decline with the reforms, but only part way to their earlier levels.

In comparing SQ88 to SQ84, disposable incomes rise for the lowest 20% of the population and fall for all other groups. The largest declines in disposable incomes in percentage terms are experienced by families with total incomes between about $24,000 and $44,000. When moving from SQ88 to the reform scenario, disposable incomes of all income groups increase. The largest increases in both dollar and percentage terms accrue to the top 1% of families. Over the whole period (SQ84 to PR88), the lowest 20% and the

Table 2.2
Summary of Aggregate Effects of Income Tax and Transfer Program Changes
(1984 $ billions)

Income or Tax Item	1984 Status Quo	1988 Status Quo	Change 1984 to 1988	1988 Post-Reform	Change due to Reform	Combined Change
				Tax Transfer Scenario		
Market Income (employment, investment, other)	262.2	262.2	--	262.2	--	--
PLUS						
Transfer						
Family Allowance	2.3	2.1	-0.2	2.1	--	-0.2
OAS	7.8	7.8	--	7.8	--	--
GIS	3.3	3.7	0.4	3.7	--	0.4
Other (e.g., UI, CAP)	26.4	26.8	0.4	27.1	0.3	0.7
EQUALS						
Total Income	302.1	302.6	0.5	303.0	0.4	0.9
MINUS						
Taxes						
Federal Income Tax	30.1	35.8	5.7	33.4	-2.4	3.3
Provincial Income Tax	20.0	22.1	2.1	21.2	-0.9	1.2
UI Premiums	3.6	3.9	0.3	3.9	--	0.3
C/QPP Premiums	2.7	3.2	0.5	3.2	--	0.5
EQUALS						
Disposable Income	245.6	237.7	-7.9	241.3	3.6	-4.3

Table 2.3
Changes in Effective Tax Rates and Disposable Income
SQ84, SQ88 and PR88

Total Income Group ($)	% of All Families	Average Total Income ($1984)	Average Effective Tax Rates(1)			Average Change in Disposable Income ($)			Average Change in Disposable Income (%)		
			SQ84 %	SQ88 %	PR88 %	SQ88-SQ84	PR88-SQ88	PR88-SQ84	SQ88-SQ84	PR88-SQ88	PR88-SQ84
0-7,120	10	4,600	-1.5	-2.5	-3.5	170	50	220	3.7	1.1	4.8
7,120-10,100	10	8,450	0.2	0.4	-0.4	140	80	220	1.7	0.9	2.6
10,100-14,270	10	12,280	3.6	5.1	3.7	-180	170	-10	-1.5	1.4	-0.1
14,270-18,840	10	16,490	7.3	10.1	8.3	-460	290	-170	-2.8	1.8	-1.0
18,840-24,260	10	21,480	11.3	14.4	12.5	-680	410	-270	-3.2	1.9	-1.3
24,260-29,990	10	27,070	14.3	17.8	16.1	-960	440	-520	-3.5	1.6	-1.9
29,990-36,310	10	33,040	17.1	20.7	19.6	-1,190	380	-810	-3.6	1.2	-2.5
36,310-44,100	10	40,000	19.1	22.4	21.4	-1,350	380	-970	-3.4	1.0	-2.4
44,100-57,010	10	49,870	20.7	23.7	22.8	-1,490	450	-1,040	-3.0	0.9	-2.1
57,010-70,670	5	62,870	22.7	25.5	24.6	-1,750	560	-1,190	-2.8	0.9	-1.9
70,670-114,490	4	83,790	24.5	26.9	26.0	-2,010	750	-1,260	-2.4	0.9	-1.5
114,490 & over	1	195,530	31.1	32.4	30.3	-2,600	4,170	1,570	-1.3	2.1	0.8
All families	100	29,780	17.8	20.5	19.3	-790	360	-430	-2.7	1.2	-1.4

Notes:

1. Includes federal and provincial PIT, UI premiums, and CPP/QPP premiums.

top 1% of families experience increases in disposable incomes; all others experience declines. In percentage terms the decreases are greatest for families with total incomes between about $30,000 and $44,000. The largest dollar gains, which accrue to the top 1%, average $1,570; the largest gains in percentage terms accrue to the lowest 20%. Based on these changes in disposable incomes over the period 1984 to PR88, the tax changes are progressive in their impact for the lowest 70% of families (i.e., up to about $36,000 in income) and regressive for the upper income 30% of families. (The words "progressive" and "regressive" are used in their technical sense; for example, progressive tax changes effect redistribution from higher to lower income groups.)

These results are illustrated graphically in Charts 1 and 2.[3] Chart 1 shows the average tax rates (ATRs) for each of the income groups for each of the three scenarios. The horizontal axis represents what we call "percentile income groups", defined exactly as in Table 2.3. This axis is not measured in dollars of income, but in percentages of the population of families sorted in ascending order of income. Generally, the population has been divided into tenths (or deciles). The exception is the top decile which has been sub-divided into the 90% to 95%, 95% to 99%, and top 1% groups. The levels of total family income (in 1984) that serve as the dividing points for these income groups are given in Table 2.3.

This detailed description of the horizontal axis in Chart 1 is emphasized for several reasons. First, many readers may find it unusual; most often, graphs of the impact of a policy change by income group use dollars of income along the horizontal axis. Second, this same horizontal axis expressed in terms of percentile income groups appears in almost all the charts to follow. Finally, this type of presentation gives a more accurate impression of distributional impacts: while there are Canadians with very high incomes, they form a small proportion of the population. With percentile income groups rather than income as the horizontal axis, the relative position of high-income families is represented more accurately.

According to the usual definition, each tax regime represented in Chart 1 is progressive throughout the entire income spectrum: taxes as a proportion of income rise continuously with increasing levels of income. (Negative average tax rates are the result of refundable tax credits.) Charts 1 and 2 also reflect the results reported in Table 2.3. The changes between SQ84 and SQ88, particularly in Chart 2, show the decline in ATRs for the lowest income group and the increases for the rest, with the middle groups experiencing the greatest increases in percentage terms. The difference between PR88 and SQ88 reflects the reductions in taxes that flow on average to all income groups. The SQ88 versus SQ84 curve in Chart 2 shows that the overall tax increase is progressive for the bottom two-thirds of the population and regressive for the top one-third. In contrast, the PR88 versus SQ88 curve appears much flatter except for the top 1%. In this context, the 1988 tax reform appears closer to being distributionally neutral than the 1984-88 tax policy changes. Finally, the PR88-SQ84 line in Chart 2 demonstrates that the reform reversed part of the tax increases during the previous period. The bottom 20% and the highest 1% emerge as the net gainers, while families in the 60th to 80th percentile ranges were the biggest losers. The tax changes appear progressive for the bottom 70% (up to about $36,000 of income) and regressive above that point.

Gainers and Losers by Income Group

Charts 3.1 to 3.3 highlight the distributions of gainers and losers in each of the three scenario comparisons. Chart 3.1, which compares SQ88 with SQ84, clearly illustrates that, except for the bottom one-fifth of the population, losers outnumber gainers at all income levels. In the first two deciles gainers dominate losers by a wide margin. From the third to the eighth deciles, losers dominate and the proportion of losers increases continuously. From the 80th percentile to the top 1% of the population, the proportion of losers declines, but still dominates gainers by large margins.

Chart 3.2, which compares PR88 to SQ88, shows that virtually everyone benefits from tax reform. On the other hand, Chart 3.3 shows that in an examination of the whole period from SQ84 to PR88, the majority of taxpayers would still have paid more income tax if the 1988 post-reform tax system had been in place in 1984. The distribution of gainers and losers by income group is notable in this comparison. For the first three decile income groups, gainers are in the majority, but the proportions decline as we move up the income scale. At the other extreme, approximately one-half of the top 1% of the population are gainers. For all the remaining middle-income groups, losers dominate gainers by large margins.

The Components of Tax Reform

Chart 4 presents an overview of the impacts of the components of tax reform as they affect the total population. Before discussing these results, a brief explanation of the procedure is required. The results displayed in Chart 4 simulate the distributional impact of each of the three components of the reform package, compared to the 1988 system without reform, as if each of these components had been enacted by itself. Thus we can examine the effect of the shift from deductions and exemptions to credits by itself, the effect of broadening the tax base by itself, and the effect of changing the rate structure (and the expansion of refundable credits) by itself. In this way we can decompose the aggregate distributional impacts shown in the earlier charts. (Note that the three components cannot simply be summed to equal the total impact because doing so would not capture interaction effects.)

The move from deductions and exemptions to tax credits (SQ88C-SQ88), on average, benefits those in the lower portion of the income distribution and increases taxes for those in the upper portion. The crossover point occurs at about the 70th percentile of the income groups. Generally speaking, the move to credits is progressive in the sense that the resulting tax changes (in percentage terms) increase with income. The exceptions to this pattern are the two tails of the income scale, the bottom 30% (though these groups are clear gainers) and the top 1%.

The base broadening component (SQ88BB-SQ88) appears to be progressive at the two tails of the income distribution – the bottom 40% and the top 1% – and basically proportional in between. As one would expect, the impact of base broadening by itself is an increase in income taxes for taxpayers at all income levels. The remaining line in

Chart 4 describes the effect of rate restructuring and the refundable federal sales tax credit (SQ88RR/FSTC-SQ88). If this set of changes alone were made, the first decile group would experience a slight decline in taxes, the next four would experience tax increases, and the remainder (approximately the top 50% of families) would enjoy tax decreases. Generally, this component of tax reform is regressive in that it confers proportionately larger benefits as incomes increase. The exception is the progressivity shown in the bottom 30% of the income distribution which reflects the enrichment of the refundable tax credits. The benefits of the lower rates are particularly pronounced in the upper portion of the income scale. For the top 1% of the population, these benefits outweigh the tax increases from the first two components of the reform.

In fiscal terms, the conversion to tax credits results in both tax increases and tax decreases and is roughly neutral overall in terms of revenue. Broadening the tax base increases total revenue. Tax rate restructuring and enrichments of the sales tax credit result in an even larger reduction in revenue.

In the analysis so far, several points stand out. There clearly has been an overall increase in personal income taxes since 1984, and this increase was moderated but not reversed by the tax reform of 1987-88. Within that general pattern two exceptions stand out. The 20% of the population with the lowest incomes has been sheltered from the tax increases; indeed, for given total incomes, most families in these income groups had higher disposable incomes after reform than they did in 1984. These gains are attributable, for the most part, to the enrichments in the refundable child tax credit that occurred during this period, the introduction and subsequent enrichment of the refundable sales tax credit, and the conversion of deductions and exemptions to tax credits.

The other exception to the general pattern is the top 1% of families in the income spectrum. In the period leading up to the reform, their tax increases were more moderate than increases experienced by most of the middle- and upper-income groups, reflecting the influence of measures such as the $500,000 lifetime capital gains exemption introduced in that period. Further in the reform exercise itself, the top 1% experienced major gains, largely as a result of the rate restructuring which significantly lowered the highest marginal tax rate.

Finally, the bottom fifth and the top 1% of the income scale are exceptions to the overall pattern. Those between these tails, on average, experienced tax increases compared to their situations in 1984. In fact, the tax increases borne by this group amount to the $4.3 billion aggregate decline in disposable incomes reported in the simulations (1984 to PR88), plus an amount equal to the tax decreases flowing to the lowest 20% and the top 1% (approximately $0.5 billion).

Impacts by Family Type

We turn now to examine the impact of the three tax scenarios on three different family types. These are the FA or Family Allowance group, which includes all family units with at least one child under the age of 18, the Old Age Security (OAS) group, which includes

all family units with at least one member aged 65 or over, and the Other group which includes singles, couples with no children, and couples and single parents with only older children living at home. Chart 5 provides a first look at these groups for the SQ84 tax regime. It should be noted that the percentile income groups in this chart (and the following three) refer to the total population, not to the family type subgroups. Table 2.4 shows the proportion of each family type falling within each overall percentile income group. The FA population has above-average income while the OAS population is concentrated in the first four deciles.

In 1984 (Chart 5) the FA population in the first three decile groups (15% in Table 2.4) had negative ATRs, reflecting the operation of the refundable child tax credit. The FA line is also on average the steepest of the three, which can be interpreted loosely to mean that for the three family types considered here, the tax system is most progressive for the FA group. The ATRs of the OAS group were all positive in 1984, and the tax line for this group appears for the most part to be less progressive.[4] Finally, the remaining group (Other) faces the highest tax rates overall. Comparing Charts 1 and 5, it is evident that the differences in ATRs among families at a point in time (1984) are greater than the changes brought about by various tax policies over the 1984 to 1988 period.

Charts 6.1 to 6.3 provide comparisons among the tax scenarios for each of the three family types. In the FA population (Chart 6.1), families in the first two decile groups (9% of the FA population) experienced gains in moving from SQ84 to SQ88 (more favourable negative ATRs), reflecting enrichments in the refundable child tax credit and the new sales tax credit, but FA units in all the other income groups faced higher tax rates in SQ88 than they did in SQ84. Chart 6.1 indicates that in moving from SQ84 to SQ88, the tax structure becomes more progressive for FA family units in the first seven decile groups (56% of the FA population). Tax increases experienced by families in the top three decile groups, on the other hand, were regressive; 44% of FA family units are in these income groups.

In moving from SQ88 to PR88, Chart 6.1 shows that average tax rates fell for FA families at all income levels. As was the case for all family groups combined (Chart 2), the curve is relatively flat, suggesting that the reform initiatives were roughly distributionally neutral for the FA population. The comparison of the reform regime with 1984 incorporates the two earlier changes. The first three decile groups enjoyed lower average tax rates. The next group, up to the highest percentile, experienced increased tax rates, with the increases being progressive through the seventh decile group. The average tax rate for families in the top 1% of the income scale (1.4% of FA units) declined after tax reform compared to 1984.

For the OAS population (Chart 6.2), families in the first decile group (14% of the OAS total) experienced, on average, reduced ATRs when moving from SQ84 to SQ88, reflecting the introduction of the refundable sales tax credit during this period. OAS family units in all the remaining income groups faced higher tax rates. Those in the second decile group (26% of the OAS group) and the top 1% (0.7% of the OAS group) experienced the smallest relative tax increase. Between SQ88 and PR88, average tax rates fell for all income groups, with those in the fifth and sixth decile groups enjoying the

largest percentage declines. Finally, in comparing the post-reform 1988 system with 1984, average tax rates fell for those in the first five decile groups and for those in the top 1%. The remainder, 19% of the OAS population, experienced tax rate increases.

Table 2.4
Distribution of Family Type Subgroups by Percentile Income Group

Percentile Income Group (%)	Income Range ($)	(Percentages) Family Type Subgroup FA	OAS	Other	Total Population
0-10	0 - 7,120	4	14	13	10
10-20	7,120 - 10,100	5	26	7	10
20-30	10,100 - 14,270	6	17	10	10
30-40	14,270 - 18,840	7	14	10	10
40-50	18,840 - 24,260	10	8	11	10
50-60	24,260 - 29,990	12	6	10	10
60-70	29,990 - 36,310	13	4	10	10
70-80	36,310 - 44,100	15	4	9	10
80-90	44,100 - 57,010	15	3	9	10
90-95	57,010 - 70,670	7	2	5	5
95-99	70,670 - 114,490	5	2	5	4
99-100	114,490 & over	1	1	1	1
	Total (%)	100	100	100	100
	Total (Millions of Families)	3.7	2.0	4.3	10
	Average Income ($000)	36.8	19.0	28.9	29.8

Note: Percentages may not add to 100 due to rounding.

Perhaps the most interesting results in Chart 6.2 are that, in the PR88 scenario, OAS family units in the first five decile groups were gainers compared to their situations in both SQ88 and SQ84. About 80% of OAS family units fell into these first five decile groups. Their gains in disposable incomes ranged from about $10 to more than $500 per family unit (compared to 1984), or about $20 to $660 per unit compared to SQ88. In addition, the OAS families in the top percentile (0.7% of OAS families) were also better off

than they were in either of the two previous tax regimes. The OAS group thus stands out in that over the entire period about 80% of the family units in this group experienced declines in their average tax rates. What appears to account for these changes are the introduction and later enrichment of the sales tax credit and the switch from deductions and exemptions to credits, particularly of those items directed specifically to the over-65 population.

The distributional impacts on the remaining population group (Other) are presented in Chart 6.3. Between SQ84 and SQ88, the average tax rate fell for the first decile group (13% of the Other population) and increased for all other groups at fairly uniform rates in percentage terms. In moving from SQ88 to the post-reform system, average tax rates fell at all income levels. Again the decline was fairly uniform in percentage terms, with the exception of the top 1% which received the largest decrease. Comparing the post-reform system to 1984, the chart shows that the first decile group and the top 1% group enjoyed reduced average tax rates. Indeed, the average gains in disposable income for the latter group amounted to $1,500. All other family units in this group gained compared to SQ88 but lost compared to SQ84. The average tax increases (since 1984) were at fairly uniform rates.

This examination of distributional impacts by family type suggests that some care was taken in the design of the changes with respect to at least two groups. Elderly family units, those containing at least one person aged 65 or older, have clearly done well relative to other groups and relative to their position in 1984. Families at the low end of the income scale have also been protected. Beyond these target groups, it is also clear that family units in the top 1% of the income distribution are gainers, regardless of their family type.

Horizontal Equity

As discussed in the previous paper, one of the fundamental objectives in the design of any tax system is horizontal equity. While the concept has many facets, one indicator is the dispersion of average tax rates that occurs among families at given income levels. Table 2.5 and Charts 7 and 8 provide summaries of such variations in average tax rates (ATRs). Chart 7 shows the dispersion in ATRs for the middle 50% and the middle 90% of the population for each percentile income group in 1984. Chart 8 indicates how the cut-off points for the 90% band have moved for SQ88 and PR88. These charts were constructed as follows: within each income group families were ranked in order of ATRs. Thus, for example, the middle 90% of a given percentile income group indicates the range or dispersion of ATRs for 90% of families in that group, excluding the 5% of the group with the highest ATRs and the 5% with the lowest ATRs.

While no single description characterizes the pattern at all income levels, several points are noteworthy. Chart 7 shows that in the bottom fifth of the income spectrum, there is virtually no dispersion for the middle 50% in each income group—their ATRs are all about zero. The dispersion is widest in the fifth income decile, with the middle 50%

Table 2.5
Average Tax Rate Ranges
Selected Income Groups

	SQ84	SQ88	PR88
First Decile			
lowest 5%	-16.7	-23.3	-28.1
lowest 25%	0.0	-2.6	-3.6
median	0.0	-0.8	-1.2
lowest 75%	0.0	-0.6	-0.8
lowest 95%	3.3	4.7	3.6
Fifth Decile			
lowest 5%	-0.0	0.2	-0.6
lowest 25%	5.5	9.1	6.8
median	11.4	14.8	12.8
lowest 75%	17.4	20.6	19.4
lowest 95%	22.5	25.5	23.4
Eighth Decile			
lowest 5%	9.9	13.0	11.4
lowest 25%	16.0	19.4	18.3
median	19.3	22.7	21.8
lowest 75%	22.2	25.8	25.2
lowest 95%	27.0	30.3	29.7
95th Percentile			
lowest 5%	13.6	16.0	15.1
lowest 25%	19.5	22.2	21.3
median	23.0	25.8	24.9
lowest 75%	26.0	28.7	27.9
lowest 95%	31.3	33.9	33.0
Top Percentile			
lowest 5%	15.1	15.8	15.2
lowest 25%	24.5	26.7	25.7
median	30.5	32.6	30.6
lowest 75%	36.1	37.8	35.1
lowest 95%	44.1	44.6	41.2

paying between 5% and 17% of their income in taxes. Dispersion for the middle 90% is wider, generally about 20 percentage points throughout the income spectrum, though it is wider for the top 1%.

Turning to Chart 8, in the lowest decile group there has been a considerable increase in the spread of ATRs. This is the case in moving from SQ84 to SQ88 and again in moving to PR88. Otherwise the two sets of tax changes have had a minimal impact on the dispersion of ATRs.

Some dispersion in ATRs within income groups is probably necessary to meet the objective of horizontal equity, for example, to reflect the diversity of family sizes. Still, a range of 20- to 5 percentage points is quite wide, even for large families versus unattached individuals with the same pre-tax income. Further, Chart 8 suggests no appreciable change in dispersion, so that overall, one cannot conclude that any significant change in horizontal equity has occurred as a result of tax reform.

Marginal Tax Rates

The final and most complex part of the analysis considers how marginal tax rates change at various income levels as one moves through the three tax scenarios. An important goal of tax reform is to reduce the disincentives to work and investment, so that "[t]he reformed tax system will increase incentives to work and invest. Lower tax rates will enable Canadians to keep more of every dollar they earn, to spend or save as they see fit."[5]

Marginal tax rates are often the focus of attention in discussions of incentive effects of the income tax system. If a taxpayer is in a 40% marginal tax bracket, for example, he or she will have available as disposable income only $0.60 out of every extra dollar of taxable income. The general view is that if marginal tax rates are high, the incentive for individuals to earn more income through work or saving will be diminished.

In practice, the determination of marginal tax rates is very complex. The relatively simple pattern of statutory rates bears little resemblance to the effective marginal tax rates actually experienced by individuals. This is illustrated clearly in the series of charts in this section. The basic reasons for much of the complexity, and indeed the perversity, of actual marginal tax rates are the large number of programs and tax provisions that have implicit marginal taxes built into them and the often subtle ways they interact.

Before launching into this analysis of the impact of tax policy changes on effective marginal income tax rates, an important caveat must be stated—the analysis omits two major programs with very high implicit marginal tax rates. These are social assistance or general welfare, and unemployment insurance. Typically, these programs are subject to 100% marginal tax-back rates—one extra dollar of income results in a one-dollar reduction of benefits. The reader should bear in mind, when examining the charts in this section, that none of these instances of very high effective, albeit implicit, marginal income tax rates are being taken into account.

We begin with an examination of the marginal tax rates on wages. In the simulation experiment, the "head" of every family is given a $1,000 increase in wages (irrespective of whether he or she has any wage income to start). The effective marginal tax rate (MTR) is then defined as one minus the increase in the family's disposable income divided by 1000.[6]

Because family circumstances vary, the most interesting approach is to examine the variations or dispersion in marginal tax rates. These are shown for the SQ84 scenario in Chart 9. This chart is similar in composition to Chart 7 which showed the variation in average tax rates. Within each of the income groups along the horizontal axis, families were sorted in ascending order of their marginal tax rates. Then the cut-off points were found that bracket the middle 50% and the middle 90% of families (that is, 5th, 25th, 75th, and 95th percentiles of marginal tax rates within each income group).

As shown in Chart 9, marginal tax rates (in 1984) for wage incomes ranged from zero to almost 100% at the lower end of the income spectrum. This range narrows as one moves up the income scale, except for the highest 1% of families. At least 5% of families in the bottom half of the income spectrum faced a zero marginal tax rate on wage income. For the upper two-thirds of the income spectrum, marginal tax rates rise, but more gradually than one might expect from examining the statutory rate structure.

It is quite difficult to track precisely all the tax and other provisions that explain this pattern. Some are discussed below. The main reason for the high marginal rates for some families at the lower end of the income spectrum is the 50% tax-back in the Guaranteed Income Supplement (GIS) and the 75% tax-back in the Spouses' Allowance (SPA), both programs for the elderly, and the 50% tax-backs in provincial programs to top up the GIS, which are "stacked" on top of the GIS and SPA tax-backs. To the extent that individuals in these families are not in the labour force, these high marginal rates would not be of particular concern for policy purposes. For our purposes, this result is limited to a small segment of the population and does not appreciably affect overall patterns or the changes between tax policy scenarios.

Chart 10 shows the impact of the tax policy changes since 1984 on the variability in marginal tax rates on wages as it affects the middle 90% of families in each income group. The basic impression to be drawn from this chart is that overall variability in the marginal tax rates on wage income has been largely unaffected by changes in tax policy since 1984. However, for some income ranges there does appear to be an increase in variability between 1984 and SQ88 and a subsequent partial reversal of that movement with reform.

Charts 11.1 to 11.3 focus on the marginal tax rate changes at the individual family level resulting from the various tax policy changes. Even though Chart 10 paints a picture of overall stability, these charts show that there has been some degree of "churning" in the marginal tax rates faced by particular families. For example, Chart 11.1 indicates that in the bottom half of the income spectrum, 5% of families faced increases in marginal tax rates of about 20 percentage points or more. This could be attributable to a mixture of the abolition of the $200 basic federal tax reduction, the 5%

tax-back on the new refundable sales tax credit, and the partial de-indexing of tax brackets and exemptions pushing families into higher tax brackets.

Another observation in Chart 11.1 is the small reduction in marginal tax rates for 5% of families in the upper half of the income spectrum. This may be attributable in part to the lowering of the income threshold at which the child tax credit begins to be phased out. In part, it may also reflect the $500,000 lifetime capital gains exclusion introduced in 1985. This interesting interaction could occur if the capital gains exclusion lowered taxable incomes sufficiently to drop some families into a lower tax rate bracket, thereby lowering their marginal tax rate on wage income as well.

Chart 11.2 suggests that about half of all families in all but the bottom fifth of the income spectrum can expect to face an increase in marginal tax rates on wage income under PR88 compared to SQ88. This result certainly appears inconsistent with the announced changes in statutory rates. There may be several factors in the explanation, however. The definition of taxable income is substantially changed by the reform proposals – the exemptions and deductions converted to credits are no longer deducted from total income to compute taxable income. Thus the same total income will place some taxpayers in a higher tax bracket than before, even though the higher tax is subsequently offset by the new tax credits. Similarly, the base broadening measures will tend to produce a higher increase in taxable income for a given increase in wage income. Of particular importance in accounting for these increased MTRs for families whose head had no wage income, is the abolition of the $500 standard employment expense deduction. A larger proportion of the top 1% of families experienced declines in MTRs than experienced increases. Chart 11.3 shows the combined effect of the tax changes covered in Charts 11.1 and 11.2.

Chart 12 begins a similar examination of marginal tax rates on interest income. The main difference between the treatment of wage income and interest income in 1984 is the $1,000 investment income deduction, which was abolished as part of the base broadening provisions of the tax reform. The elimination of the deduction, together with the fact that a large proportion of families have no interest income, probably accounts for the large number of families throughout the income spectrum who, in 1984, faced essentially a zero marginal tax rate on interest income. Again, the very high marginal tax rates faced by a smaller fraction of families at the lower end of the income spectrum is likely accounted for by the tax-backs in GIS, SPA and the provincial top-ups for the elderly.

Chart 13 shows some narrowing in the range of marginal tax rates on interest income in the upper half of the income scale. The small change from SQ84 to SQ88 is probably attributable to the decline in the real value of the $1,000 investment income deduction, which was not indexed. The larger narrowing from SQ88 to PR88 is accounted for by the abolition of this provision.

Chart 14.1 shows a pattern similar to the corresponding chart for wage income (Chart 11.1), except at the top of the income spectrum, where a few families experience a larger drop in marginal rates. The large increase in marginal rates on interest income in Chart 14.2 (which compares PR88 to SQ88) for most families throughout the income

spectrum results from the abolition of the $1,000 investment income deduction. Chart 14.3 displays the combined effects in the previous two charts.

Chart 15 begins the examination of marginal tax rates on dividends. The most striking observation here is that more than half of all families in the middle to upper portion of the income spectrum faced a negative marginal tax rate on dividends in 1984. The reason is that for these families, the extra dividend income did not generate any additional taxable income because it was sheltered by the $1,000 investment income deduction. However, the extra dividend income did generate a dividend tax credit for the taxpayers. At the same time, some filers at the lower end of the income spectrum faced very high marginal rates on dividends (and as Chart 18 below shows, on capital gains as well). This occurred in the case of elderly families receiving the GIS and provincial supplements (e.g., GAINS in Ontario). Their supplements were reduced in light of extra investment income, thereby yielding a high effective marginal tax rate.

The bottom set of curves in Chart 16 shows that these negative marginal tax rates first declined between SQ84 and SQ88, then virtually disappeared with tax reform (PR88). The reason for these shifts is the decline in the magnitude of the dividend tax credit and the abolition of the $1,000 investment income deduction under tax reform. The reduction of the dividend tax credit and the associated dividend gross-up also account for the increased marginal tax rate at the 95th percentile cut-off in the top half of the income spectrum. The marginal tax rates for some families in the lower portion of the income scale approach 100%. This is the result of the interaction of the dividend gross-up provision and the tax-backs applicable to the GIS, SPA, and provincial top-ups for the elderly.

Charts 17.1 and 17.2 reflect the same interactions. In Chart 17.1, the increase in marginal rates between SQ84 and SQ88 reflects the reduction in the dividend tax credit provision and the erosion of the investment income deduction by inflation. The further increase between SQ88 and PR88 (Chart 17.2) reflects the abolition of the investment tax credit. Again Chart 17.3 shows the combined impact of the previous two charts.

The next group of charts examines changes in marginal tax rates on capital gains. Chart 18 presents the picture for 1984. In all income groups there were some families with marginal tax rates of zero, reflecting the $1,000 investment income deduction. Chart 19 shows that the dispersion in MTRs narrows with the moves to SQ88 and PR88. Virtually all of the reduced dispersion is a reduction in the 95th percentile MTR within each income group. Between SQ84 and SQ88 the major change in capital gains taxation was the introduction in 1985 of the $500,000 lifetime exemption (in addition to the capital gains exemption that has always existed on the sale of a family's principal residence and the capital gains rollovers for family farms and small businesses). This change is reflected in Chart 20.1. The effect of the $500,000 lifetime exemption was effectively to eliminate capital gains taxation in Canada for the near term, except for a small fraction of tax filers (the 95th percentile cut-offs). (Of course, since this is a lifetime exemption, it can be expected that over time, as individuals use up their exemptions, effective marginal tax rates on capital gains will rise.)

The results in Chart 20.2 are perhaps more surprising. Tax reform reduced the lifetime exemption to $100,000 and increased the inclusion rate from 50% to 75%. Yet Chart 20.2 shows that there were few significant increases in marginal tax rates on capital gains compared to SQ88. This result reflects that (principal residences, small businesses, farms, etc. aside) few tax filers had realized capital gains in excess of $100,000 in 1984. It should be noted that this result does not recognize that in the 1985-87 period some taxpayers will have used up a portion of their lifetime exemptions. Nevertheless, it is still the case that for most families, capital gains taxation has been virtually eliminated over the near term, even after tax reform. Chart 20.3 presents the combined impact of the earlier two charts.

Charts 21.1 to 21.4 bring together the results on MTRs for the four sources of income. Charts 21.1 and 21.3 refer to SQ84, while 21.2 and 21.4 refer to PR88. Charts 21.1 and 21.2 show the 50th percentile or median MTRs within each income group for each source of income. Charts 21.3 and 21.4 show the 75th percentile or third quartile MTRs.

Comparing Charts 21.1 and 21.2, it appears that the tax changes over the 1984 to 1988 period narrowed the range of effective median MTRs. This is mainly because of the elimination of the negative MTRs on dividends. However, the narrowing of MTRs by income source is less apparent in examining the third quartile MTRs in Charts 21.3 and 21.4.

Perhaps most surprising in this set of charts is the rather flat pattern of median and third quartile MTRs across income groups. Notwithstanding the overall progressivity in terms of average tax rates, the tax system exhibits a considerable flat-tax structure in terms of marginal rates.[7]

Finally, these charts show clearly that "middle-class" sources of income—wages, and interest--post-reform are still taxed more highly at the margin than "upper class" sources of income—dividends and capital gains. Incomes at the low end of the spectrum are taxed even more highly, but this is apparent only in the charts for GIS and the provincial top-ups, because the underlying simulations do not take into account social assistance.[8]

Summary and Highlights

- Abstracting from economic growth, personal income tax increases between 1984 and SQ88 (status quo 1988) reduced disposable incomes by an aggregate of $7.9 billion (1984 dollars) or 3.2%. Smaller tax decreases in the 1988 reform resulted in overall disposable incomes being $4.3 billion less than in 1984, a reduction of 1.8%. On average, these declines amounted to $790 and $430 per family respectively.

- Overall, Canada's personal income tax is progressive and remained so throughout the 1984 to 1988 period. During that time, effective average tax rates declined for the lowest 20% of families between 1984 and SQ88, and between 1984 and PR88 (post-reform 1988). The top 1% of families experienced an increase in average tax

rates between 1984 and SQ88, but an even larger decrease in moving to PR88. Over the entire period, tax changes were progressive for the lowest 70% of families (up to about $36,000 in income in 1984) and regressive for the upper 30%.

- Comparing the post-reform system to SQ88, virtually all families benefit. When 1984 is used as the basis of comparison, gainers outnumber losers in the bottom 30% of the population and in the top 1%. For all other income groups, the number of losers dominates the number of gainers by large margins.

- Considerable variation in average tax rates is evident across family types. The lowest 15% of the Family Allowance population had negative average tax rates in 1984 and they experienced gains in moving to SQ88 and again in moving to the post-reform scenario. These gains reflect the enrichment of the refundable child tax credit and the introduction and later enrichment of the refundable sales tax credit. The remainder of the Family Allowance population experienced tax increases between 1984 and SQ88; they then became gainers in moving to PR88. The post-reform tax decreases (compared to SQ88) were distributionally neutral for this group, except for the top 1% whose gains were large enough to outweigh earlier tax increases.

  About 80% of the Old Age Security (OAS) population were gainers in tax reform compared to both SQ84 and SQ88. The OAS population in the top 1% of the overall population is also better off. The sales tax credit and the switch from deductions and exemptions to credits appear to account for these gains.

  In moving from 1984 through the post-reform scenario, the bottom 13% and the top 1% of the remaining population group (Other) either remained unaffected or gained, while the rest of this group experienced tax increases at fairly uniform rates.

- With respect to horizontal equity, there are considerable variations in the average income tax rates of families at all points in the income spectrum. The range is about 20 to 25 percentage points for the middle 90% of families at a given income level. This variation was not altered appreciably by tax changes over the 1984-88 period.

- Effective marginal tax rates are determined in complex ways that involve the interaction of various tax measures alongside direct spending programs that have their own (often implicit) tax-back provisions. As a result, in 1984, marginal tax rates faced by families at a given income level could vary greatly; in some cases, marginal rates at lower incomes were greater than at higher incomes.

  Interesting examples of these interactions include the following:

  - The capital gains exclusion dropped some families into lower tax brackets, thereby lowering their marginal tax rates on other forms of income as well.

- Families claiming less than the full amount of the $1,000 investment income deduction could still claim the dividend tax credit, resulting in a negative marginal tax rate on dividends.

The removal of the $1,000 investment income deduction was an important step in closing the gap between marginal tax rates on wage income and marginal tax rates on various types of investment income for families through most of the income spectrum. For capital gains income, this shift was offset by the creation of the lifetime exemption. Even though that exemption was cut back from $500,000 to $100,000 under tax reform, it effectively eliminates capital gains taxation until these lifetime exemptions are exhausted.

As a result of the tax reform provisions, the number of families throughout the income spectrum facing increases and decreases in marginal tax rates is similar. The reform has had some effect in narrowing the dispersion in marginal tax rates among different income sources, but marginal tax rates on wages and interest income are still at least twice as high as those on dividends and capital gains.

Notes

1. The results reported here are derived from the first public release version of the SPSD/M (version 3.1) using 1984 data. An earlier version of the SPSD/M (the "beta test" version) was used to derive the results reported in an earlier discussion paper (Institute for Research on Public Policy Discussion Paper 88.C.1).

   Two main types of changes are involved in switching from the earlier to the later version of the model. First, additional policy measures are now included: the new treatment of automobile, business meal, and home office expenses; the December 1987 amendments to the original Phase I reforms (increase in the Refundable Child Tax Credit of $35, increase in the non-refundable child tax credit for third and subsequent children); and Ontario property tax grants.

   Second, Statistics Canada incorporated certain technical changes in the way individuals in the top 1% of the income spectrum were "blurred" to assure the confidentiality of these individuals' data. This results in a somewhat different distribution of investment income in all the simulation scenarios. Other, smaller changes are the result of general data refinements.

   The pattern of results reported here is consistent with those reported in the earlier discussion paper. Two differences that merit mention are 1) the improved position of taxfilers in the first two decile groups, largely reflecting the favourable impact of the December 1987 amendments; and 2) the larger (negative) change in disposable income between SQ84 and SQ88 for taxfilers in the top 1%.

   For information on the construction of the database and model see M. Wolfson et al., "The Social Policy Simulation Database. An Example of Survey and Administrative Data Integration" (Ottawa: Statistics Canada, 1988), presented at the NBER 50th Annual Conference on Income and Wealth, Washington, D.C., May 1988.

2. Average tax rates in this analysis are defined as the ratio of total income taxes paid (including UI and CPP/QPP payroll taxes) to total pre-tax income. This, in turn, is equal to one minus the ratio of disposable to total income. Total income includes market incomes from all sources plus transfers (e.g., Family Allowance, UI, pensions) from government. It does not include imputed income (e.g., from owner-occupied homes) and income in kind that are usually excluded from measures of money income. Capital gains from the sale of principal residences are also excluded, as they are in most such definitions, including the analysis in the Department of Finance White Paper.

3. All charts are included at the end of this monograph. Readers should be aware that, because the last decile group has been disaggregated into three smaller groups (90-95, 95-99, 99-100 percentile groups), the last three data points on each graph represent correspondingly fewer families than do the earlier points which each represent ten per cent of the population. This is represented in the bar graphs by adjusting the width of the columns appropriately. On the line graphs, the spacing of the data points represents the population proportions accounted for by each point.

4. It may be noted that the positive ATRs for OAS families compared to negative ATRs for FA families at the low end of the income spectrum is, in some sense, arbitrary. The reason is the classification of the Guaranteed Income Supplement (GIS) as a direct spending program, and hence not part of the tax system, while the refundable child tax credit – which is very similar in structure to the GIS – is part of the tax system. A more integrated view of the tax/transfer system would treat GIS and the child tax credit more uniformly. If this were done, ATRs for OAS families would also be negative at the low end of the income spectrum.

5. Canada, Minister of Finance, "The White Paper on Tax Reform 1987", p. 2.

6. This experiment does not capture the effects of changing the marital exemption to a tax credit. This change means that, for example, a spouse entering the labour force will face a lower MTR after tax reform. The focus of the analysis in this paper is on MTRs facing "heads" of households.

7. It is, of course, mathematically possible to have flat marginal tax rates and progressive average tax rates. See Michael Wolfson, "A Guaranteed Income", *Policy Options*, volume 7, no. 1 (January/February 1986), pp. 35-45.

8. Neither has the impact of extra income on UI benefits been simulated. While the model can analyze such impacts on the UI program, this analysis is quite complex and has been omitted here.

Conclusion

The two papers in this volume address the process of tax reform and its fiscal impact on families at different levels of income. Taken together, these analyses suggest that the tax reform of 1987-88 was the product of very careful tax architecture.

The primary objective of the government when it embarked on tax reform was to remove or reduce the influence of the tax system on private sector decision making and to enhance the influence of market forces in these decisions. More specifically, the government wanted to strengthen incentives for work and, especially, for investment, in order to stimulate economic growth. This was to be accomplished by eliminating or weakening special provisions that distorted (often deliberately) investment and labour supply decisions and by reducing tax rates and tax burdens to improve incentives.

One would expect that the most significant response to these reforms, particularly with respect to investment, would come from individuals in a position to adjust their behaviour in response to the new tax system. Strategic considerations would suggest that the tax reform focus on those groups with the flexibility and resources to respond to the altered incentives. The fact that the analysis showed major benefits flowing to the top 1% of family units in the sample is consistent with this strategy. Clearly these taxpayers are in a strong position to adjust their economic behaviour, particularly their investment behaviour. Our results indicate that they have been given the strongest incentives to do just that.

It is also noteworthy that the movement in this direction was not more far-reaching. The top 1% of families appears to be the only group in the upper portions of the income spectrum clearly to benefit. Moreover, changes in marginal tax rates, while generally in the desired direction, were quite moderate. In short, the results suggest that

tax reform may not have gone far enough to achieve the government's own objectives. While most deductions and exemptions were converted to tax credits, very few were eliminated. The broadening of the personal income tax base was, therefore, quite modest; as a result, the scope available for lowering tax rates was also limited.

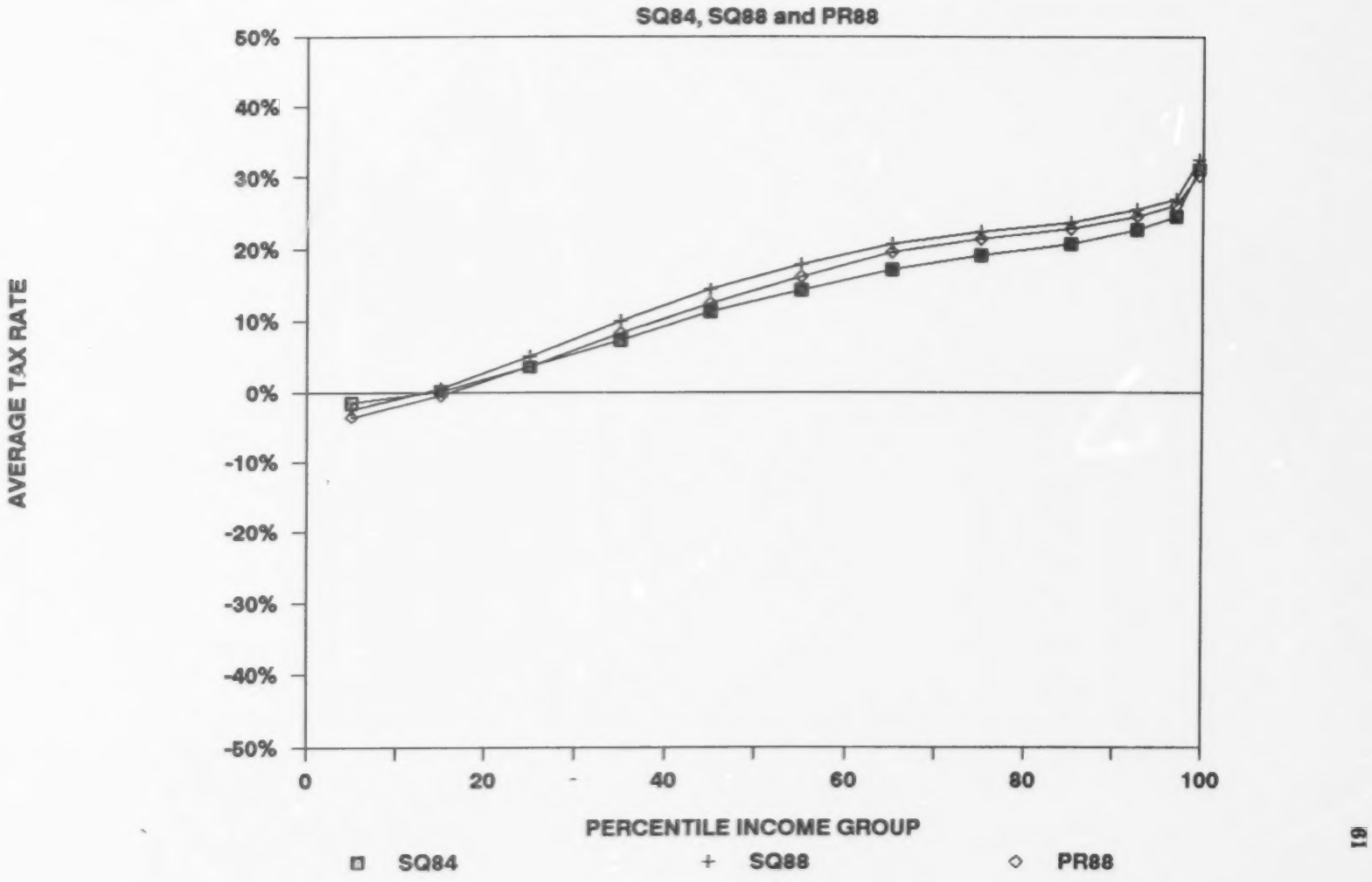
This moderation in tax reform may be explained by the strength of the *status quo*. Previous attempts to broaden tax bases (remove tax preferences) have created a great deal of difficulty for governments. These problems can be avoided, or at least limited, by enacting less radical reforms. And indeed, it is the case that the Mulroney government has been more politically successful with its income tax reforms than its predecessors in 1970-71 and 1981. Ultimately, then, the government's success and lack of success are attributable to the same factors.

While focusing on its primary objective, the government clearly saw the need to protect, and if possible to enhance, the position of highly visible social groups that were commonly regarded as being disadvantaged. The simulation results show this strategy at work most clearly with respect to the low-income elderly population, but it is also evident with respect to low-income families with children.

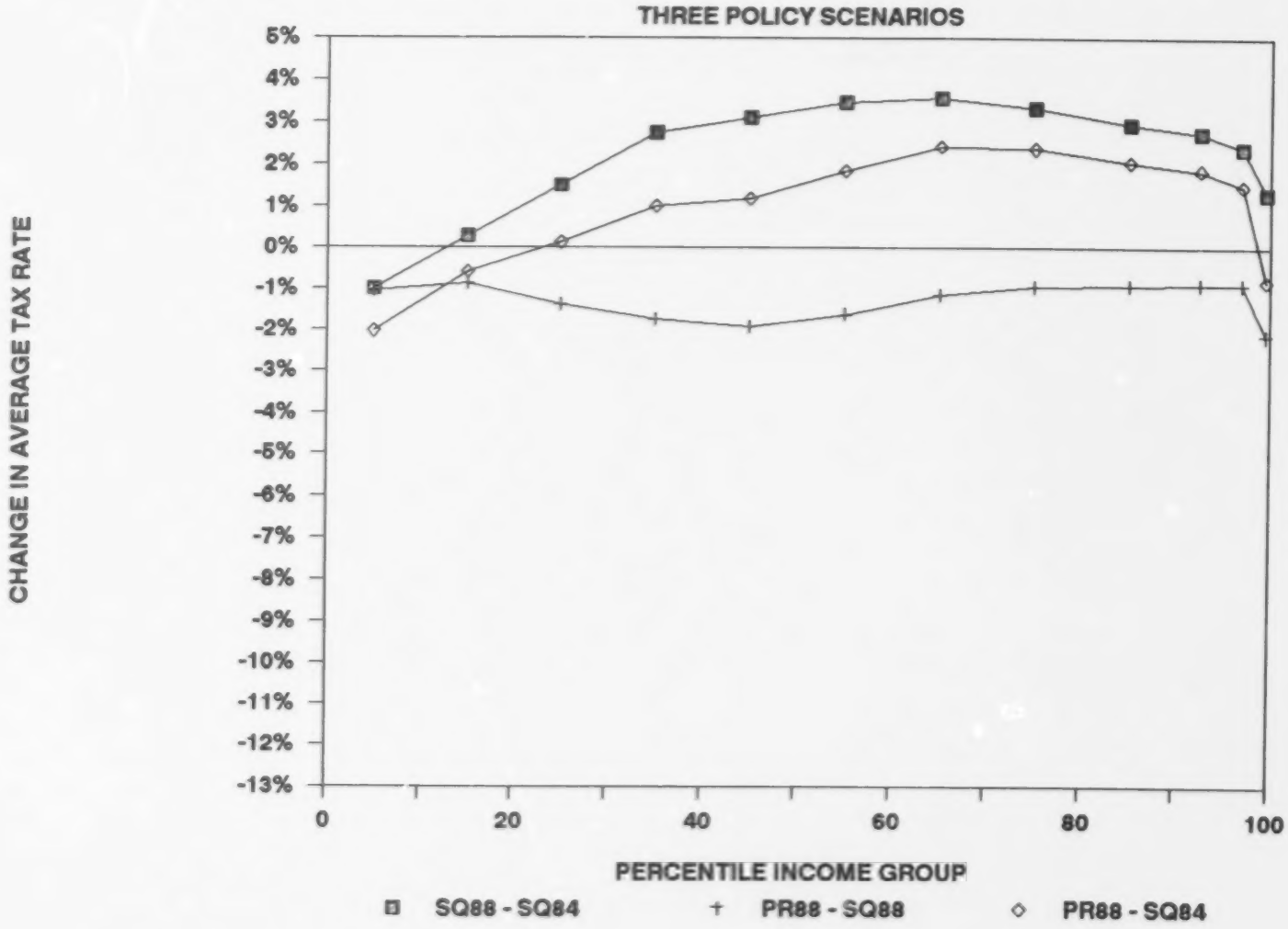
These changes must of necessity leave others to bear the burdens of adjustment. This was achieved partly by shifting approximately $2.4 billion in annual tax revenues out of the personal income tax and into other tax revenue sources (compared to 1988 without reform). It was also achieved by increasing the tax burden on the broad range of middle-income taxpayers.

Charts
for
Part II on
The Distributional Impacts of Personal Income Tax Reform, 1984 to 1988

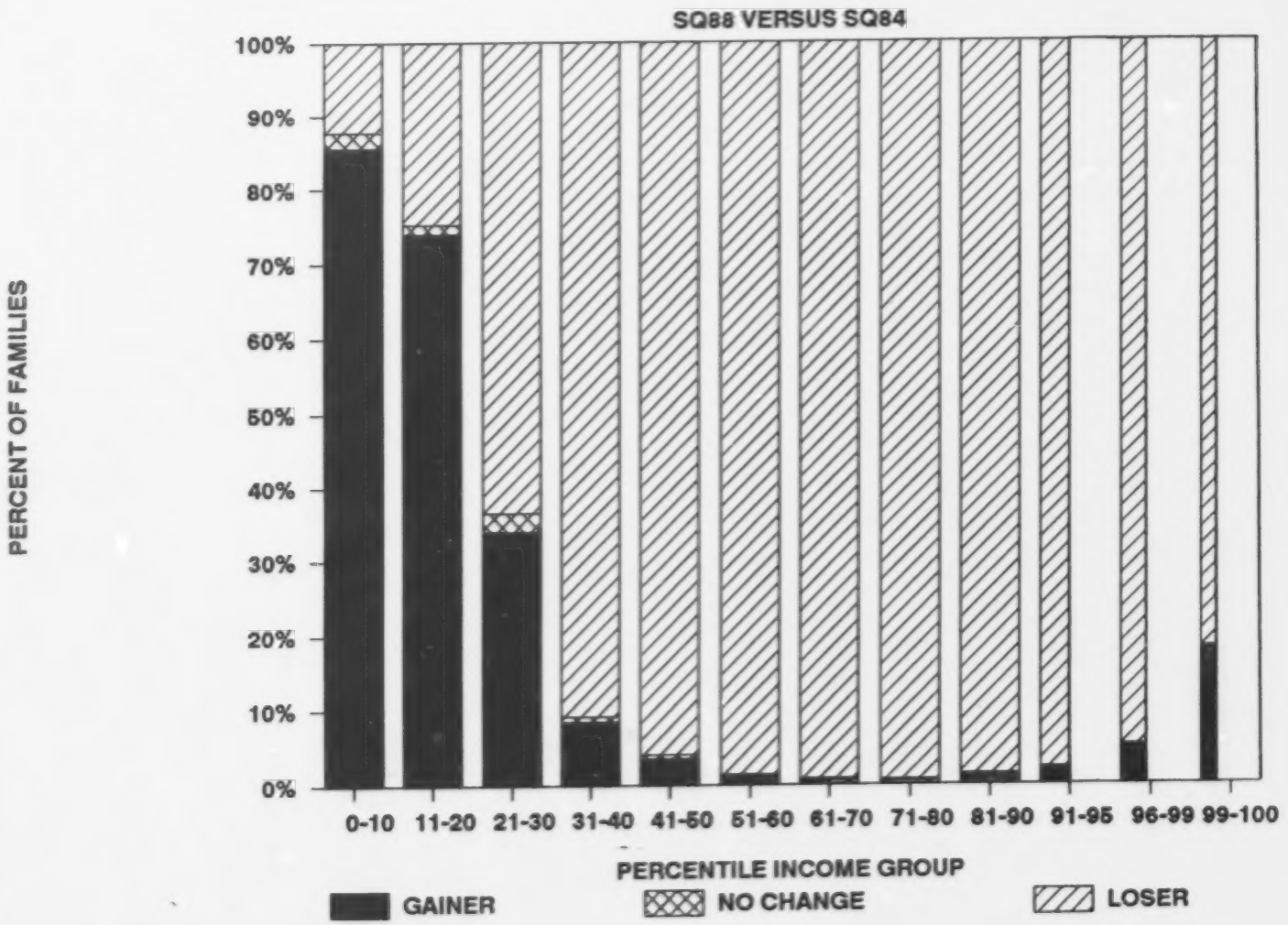
1. AVERAGE TAX RATES BY PERCENTILE INCOME GROUP



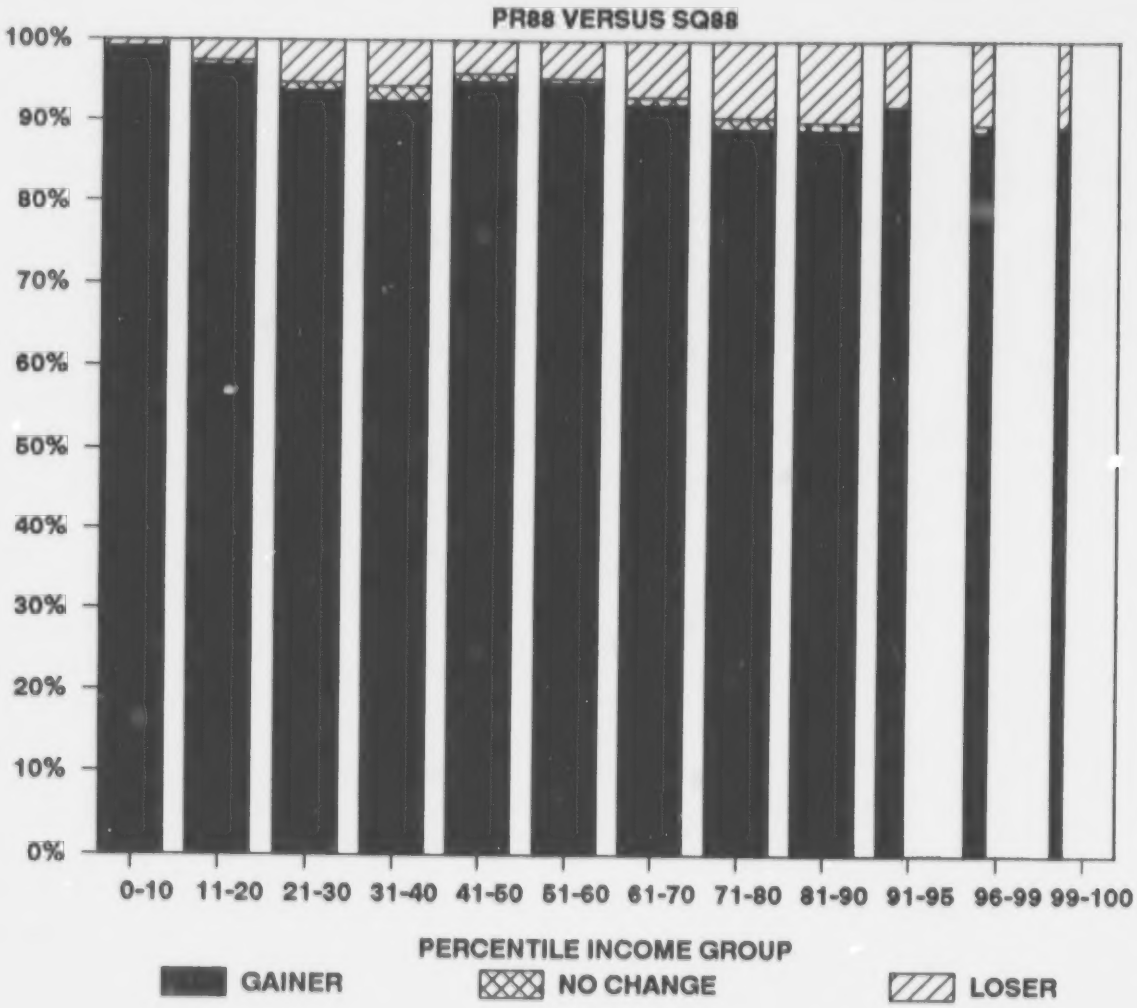
2. CHANGE IN AVERAGE INCOME TAX RATES



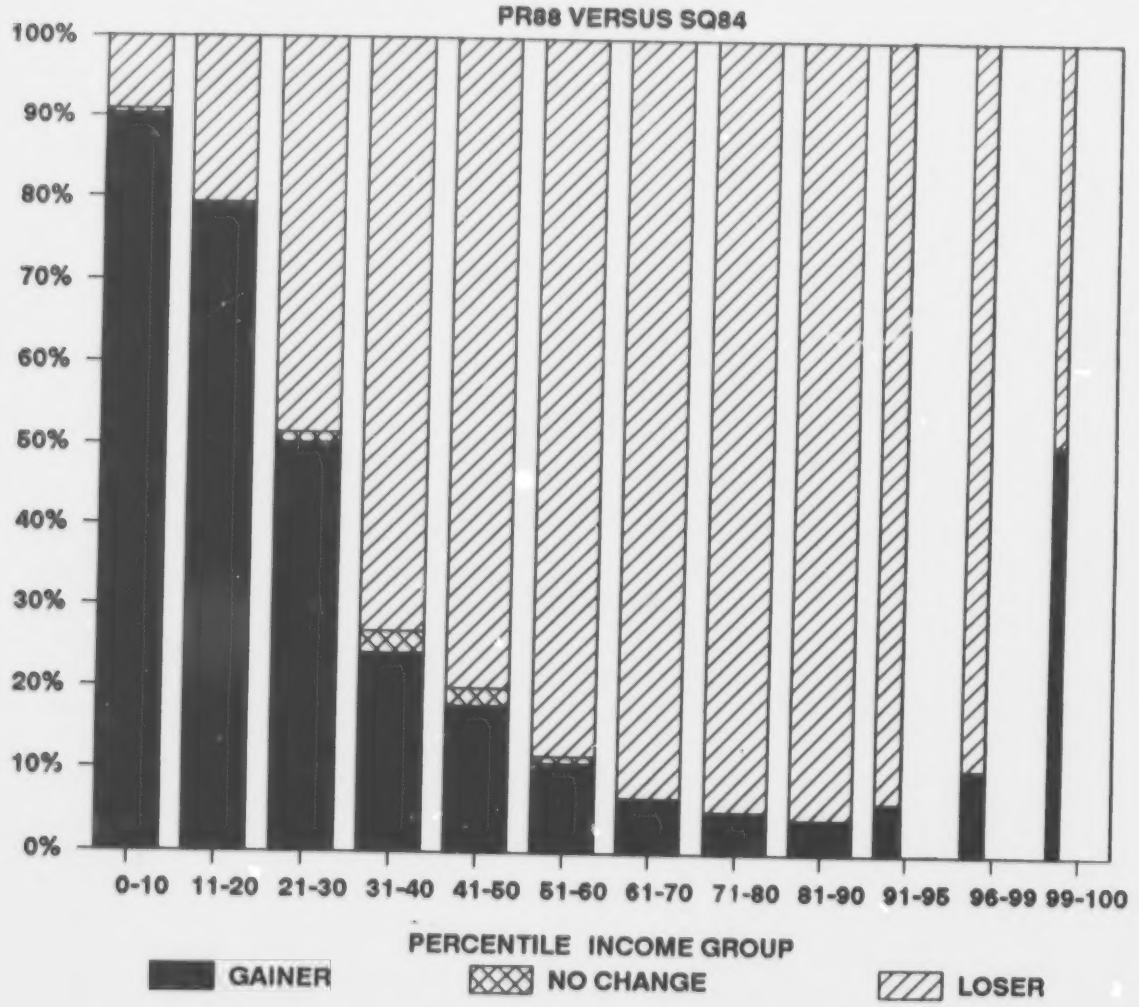
3.1 DISTRIBUTION OF GAINERS AND LOSERS (%)



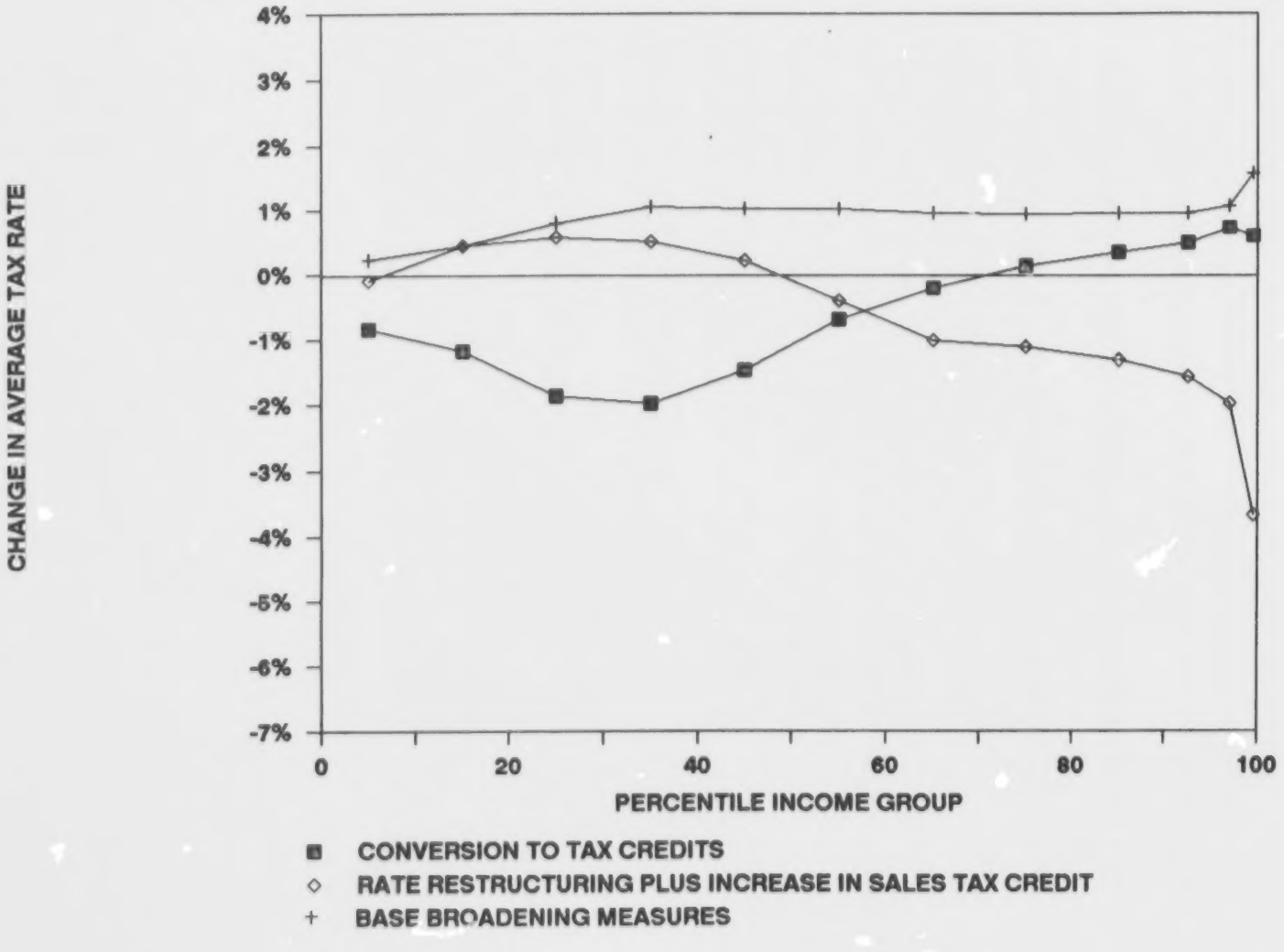
3.2 DISTRIBUTION OF GAINERS AND LOSERS (%)



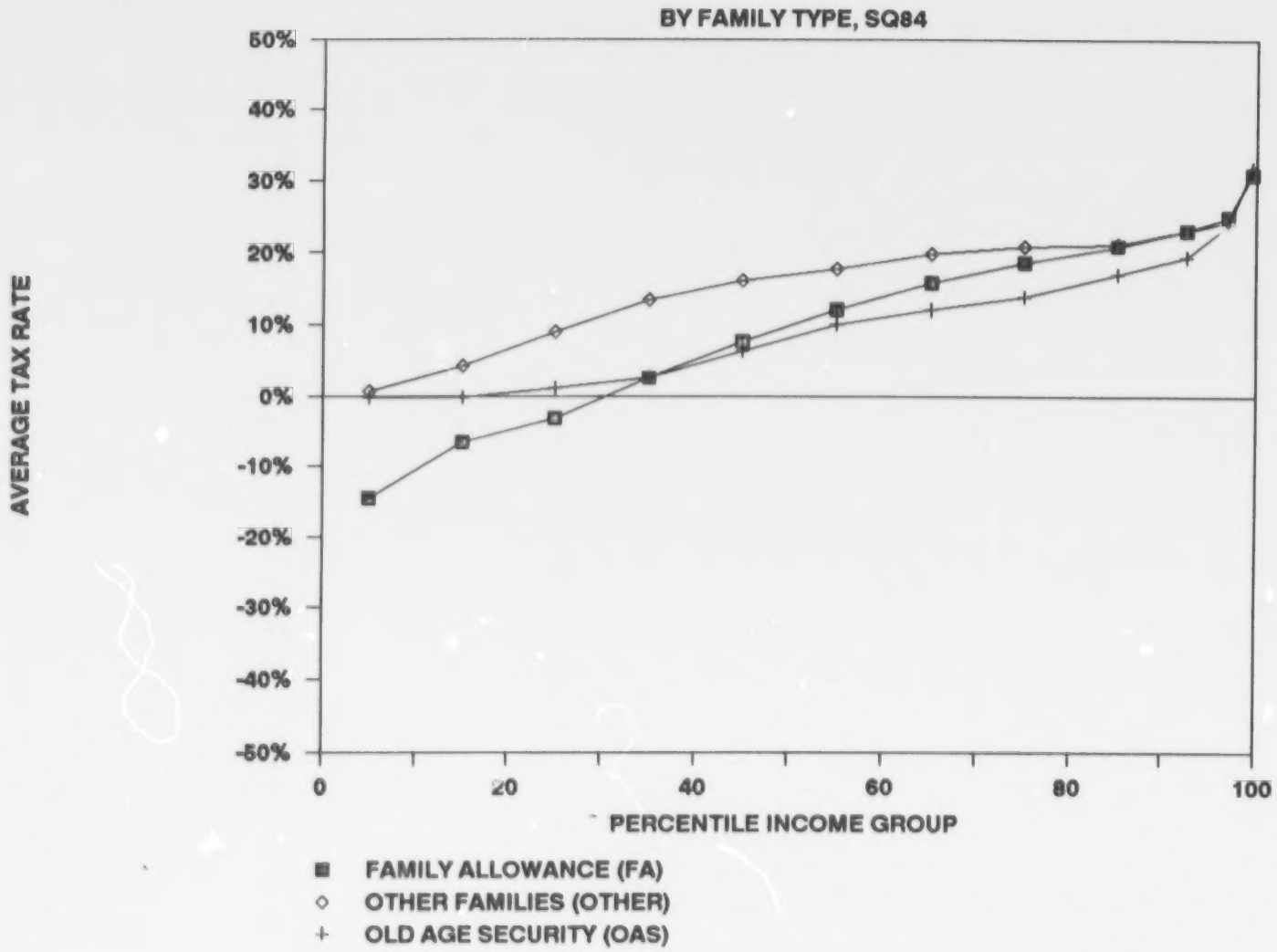
3.3 DISTRIBUTION OF GAINERS AND LOSERS (%)



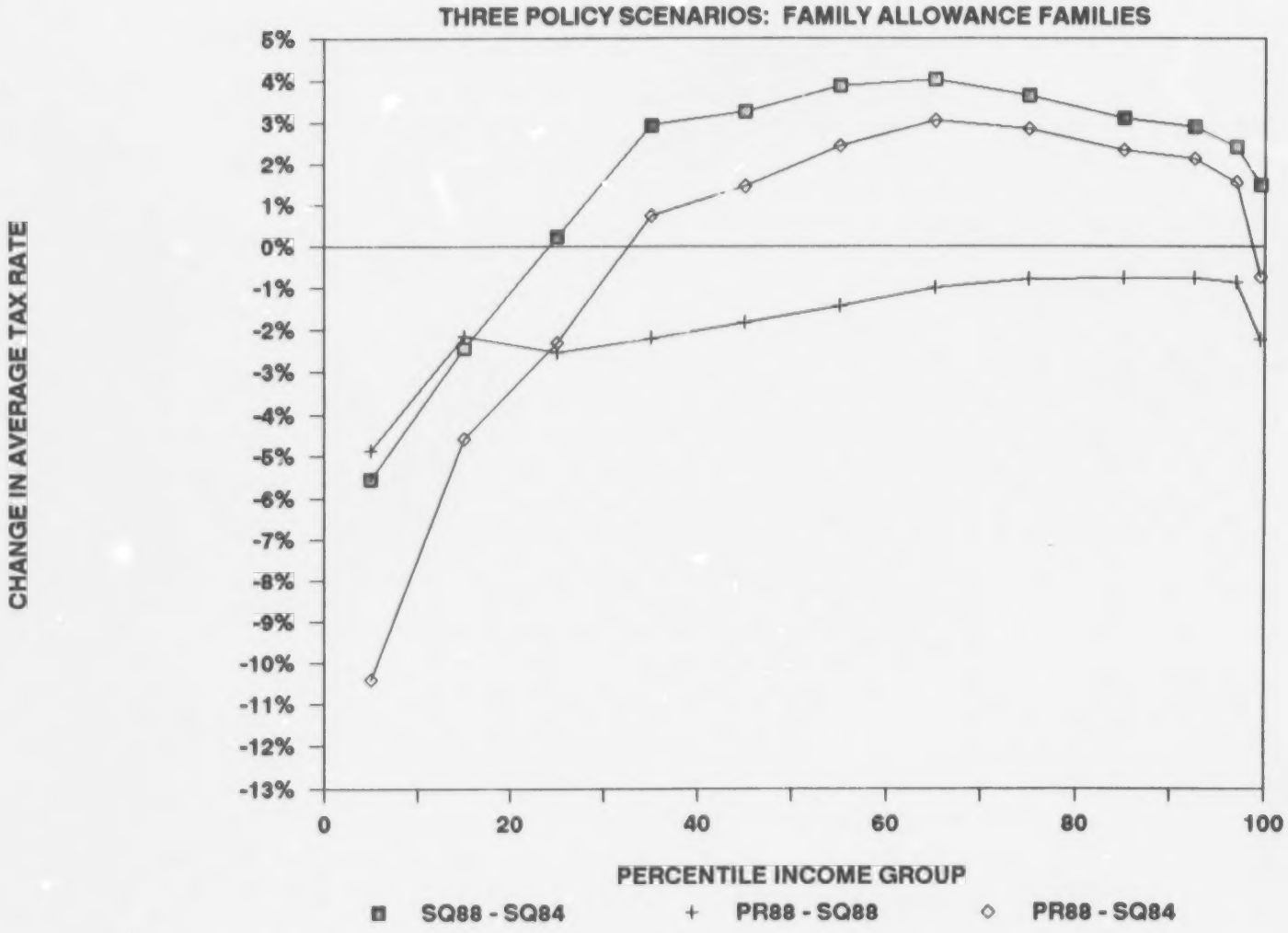
4. DECOMPOSITION OF TAX REFORM IMPACTS



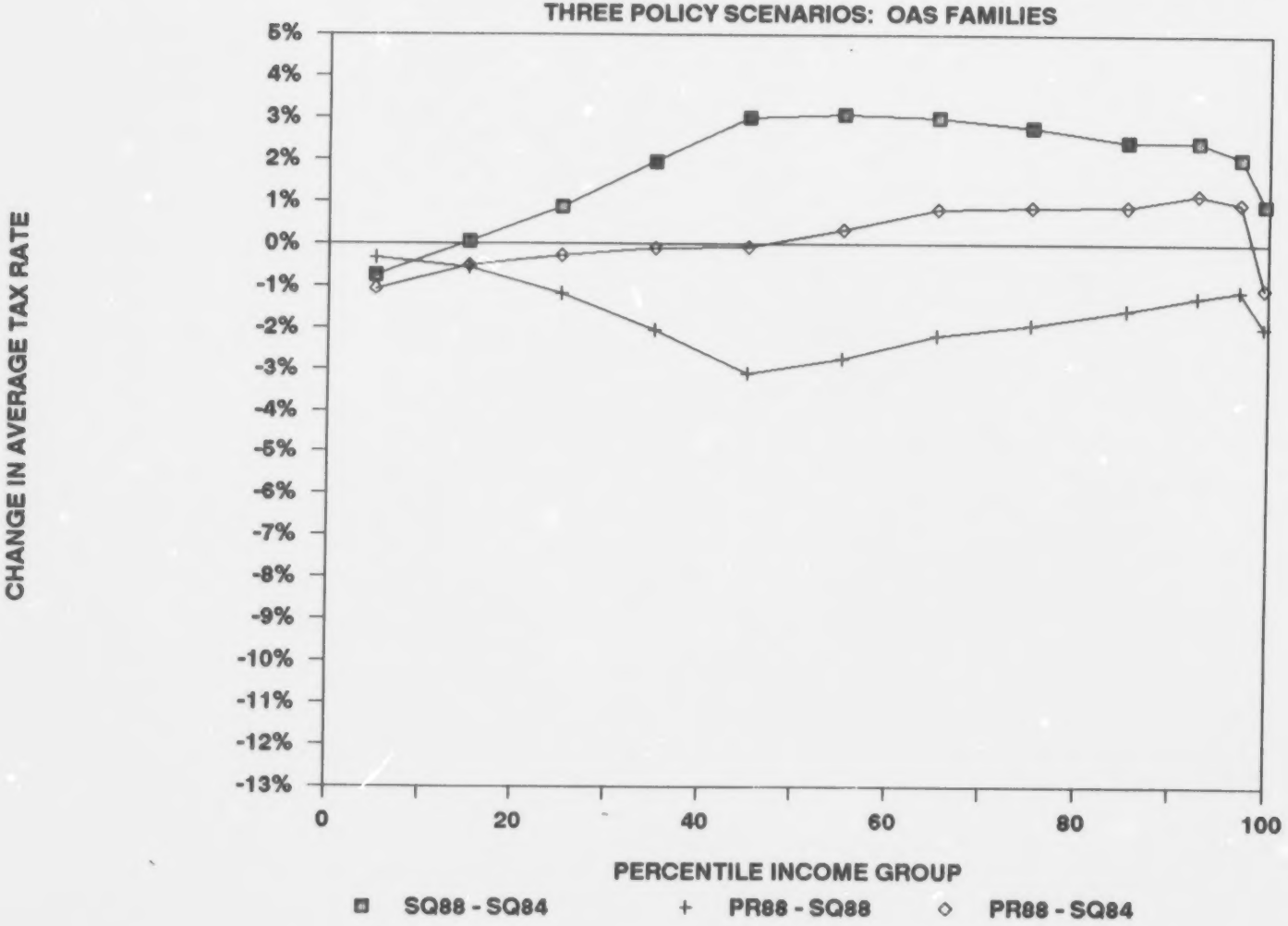
5. AVERAGE INCOME TAX RATES



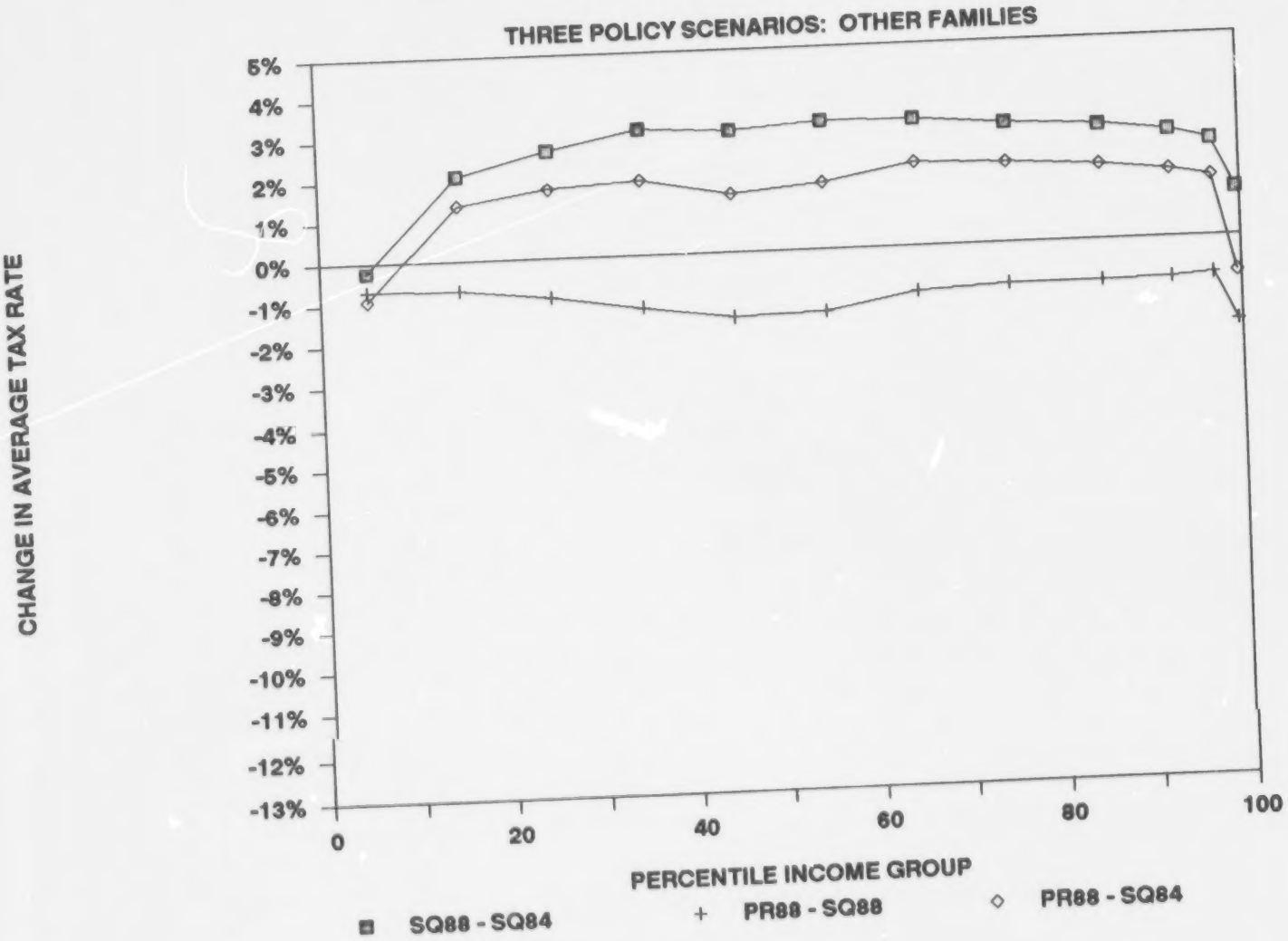
6.1 CHANGE IN AVERAGE TAX RATES



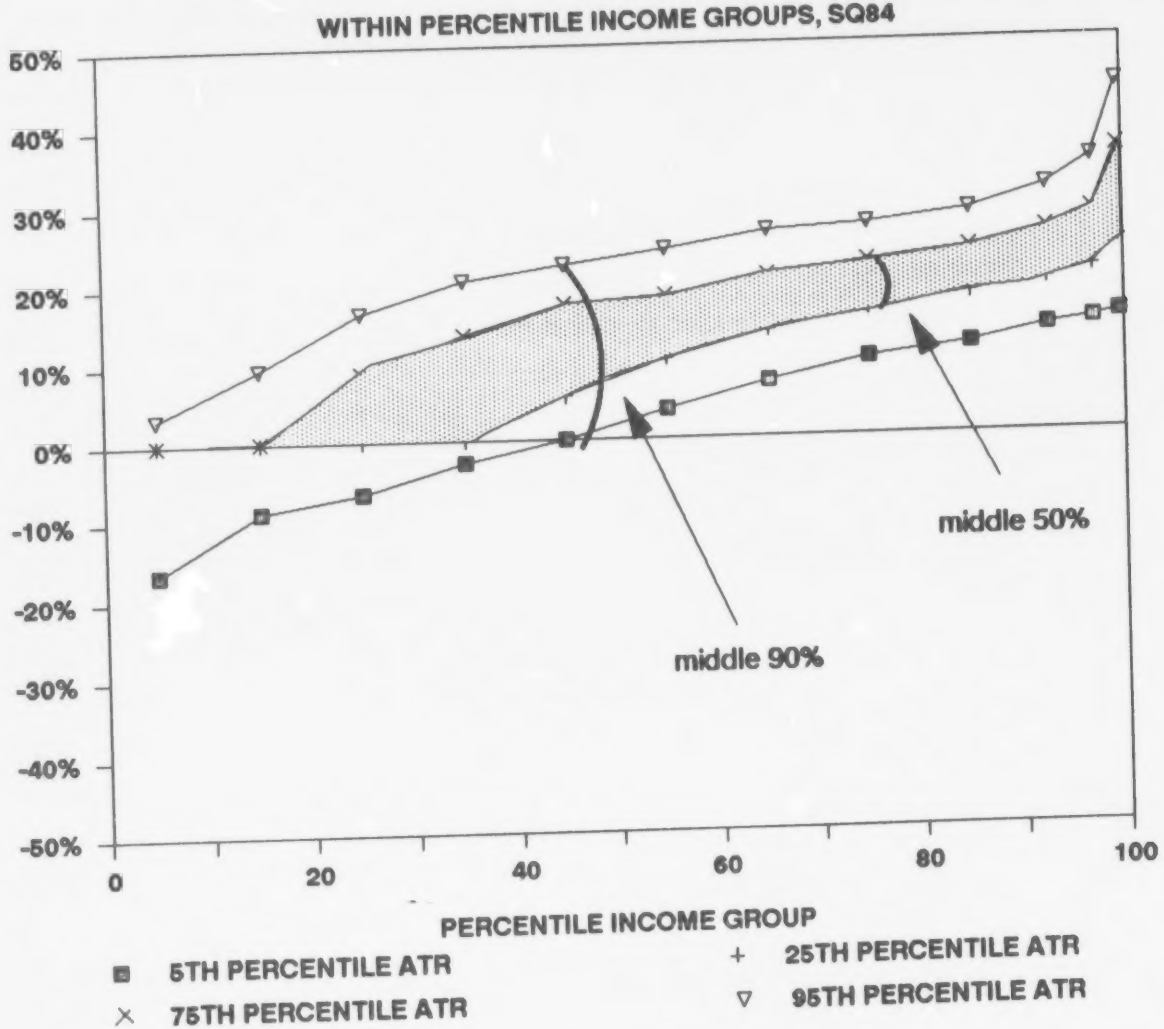
6.2 CHANGE IN AVERAGE TAX RATES



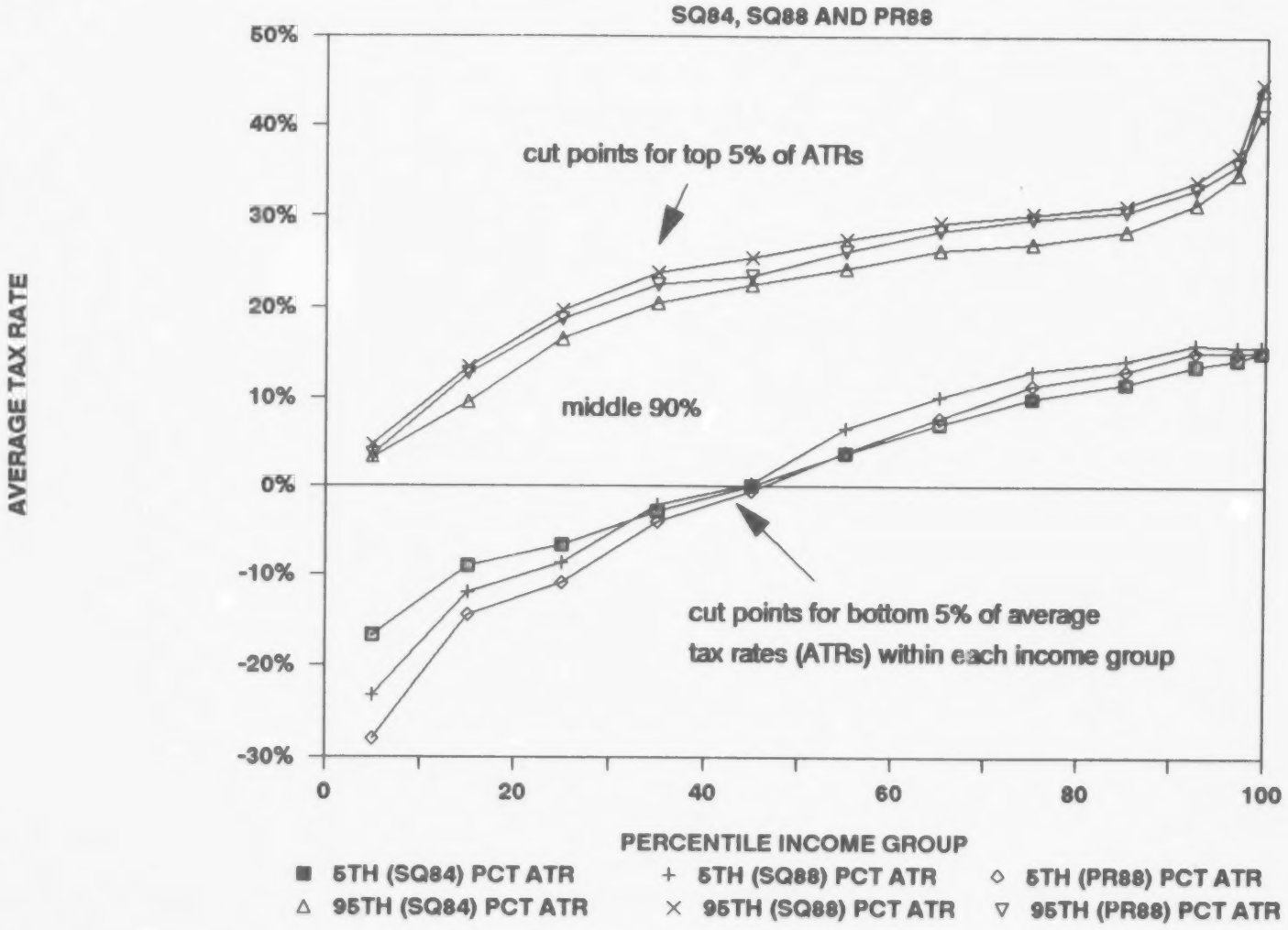
6.3 CHANGE IN AVERAGE TAX RATES



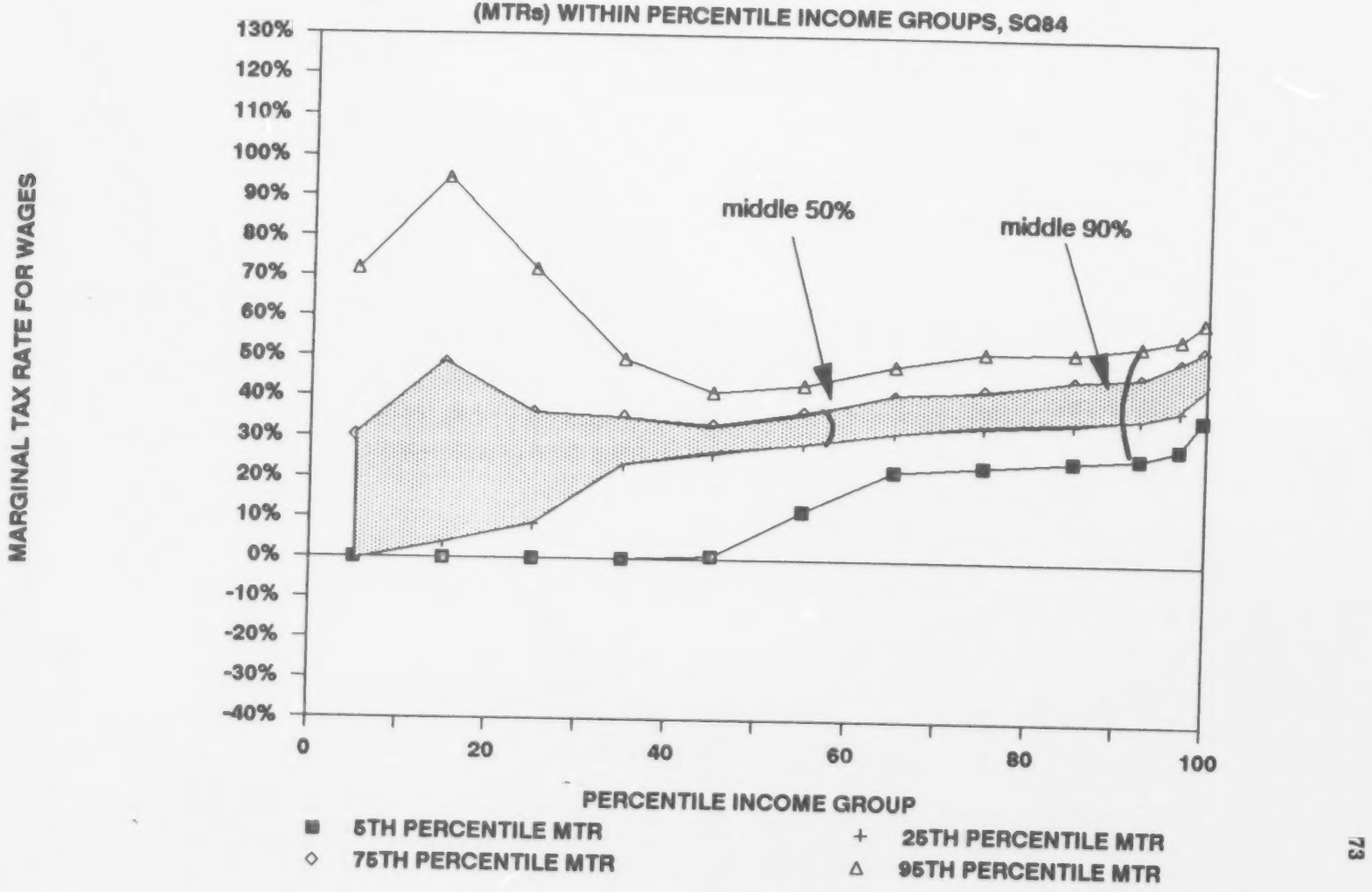
7. VARIATIONS IN AVERAGE INCOME TAX RATES



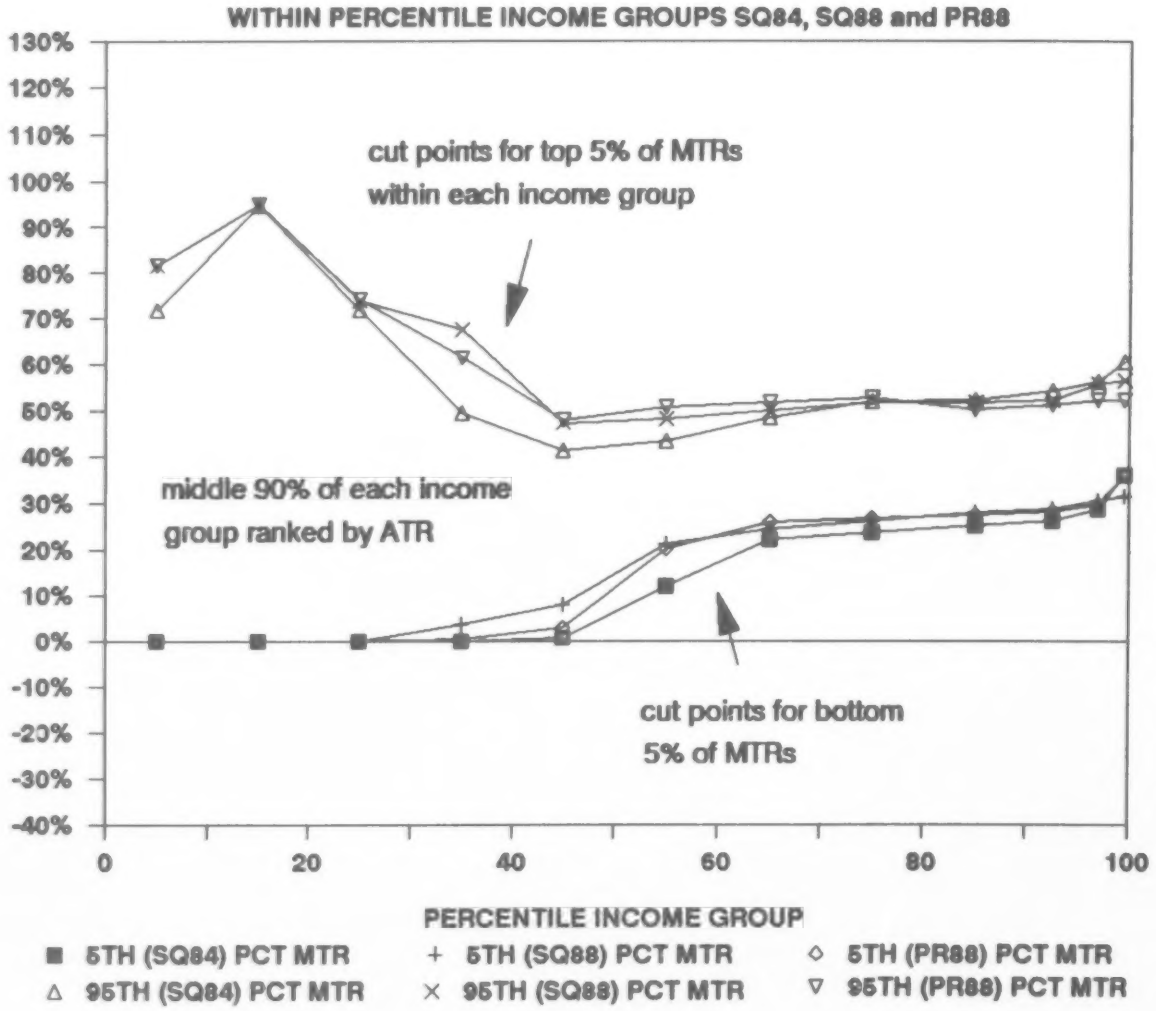
8. COMPARISON OF THE VARIABILITY IN ATRs



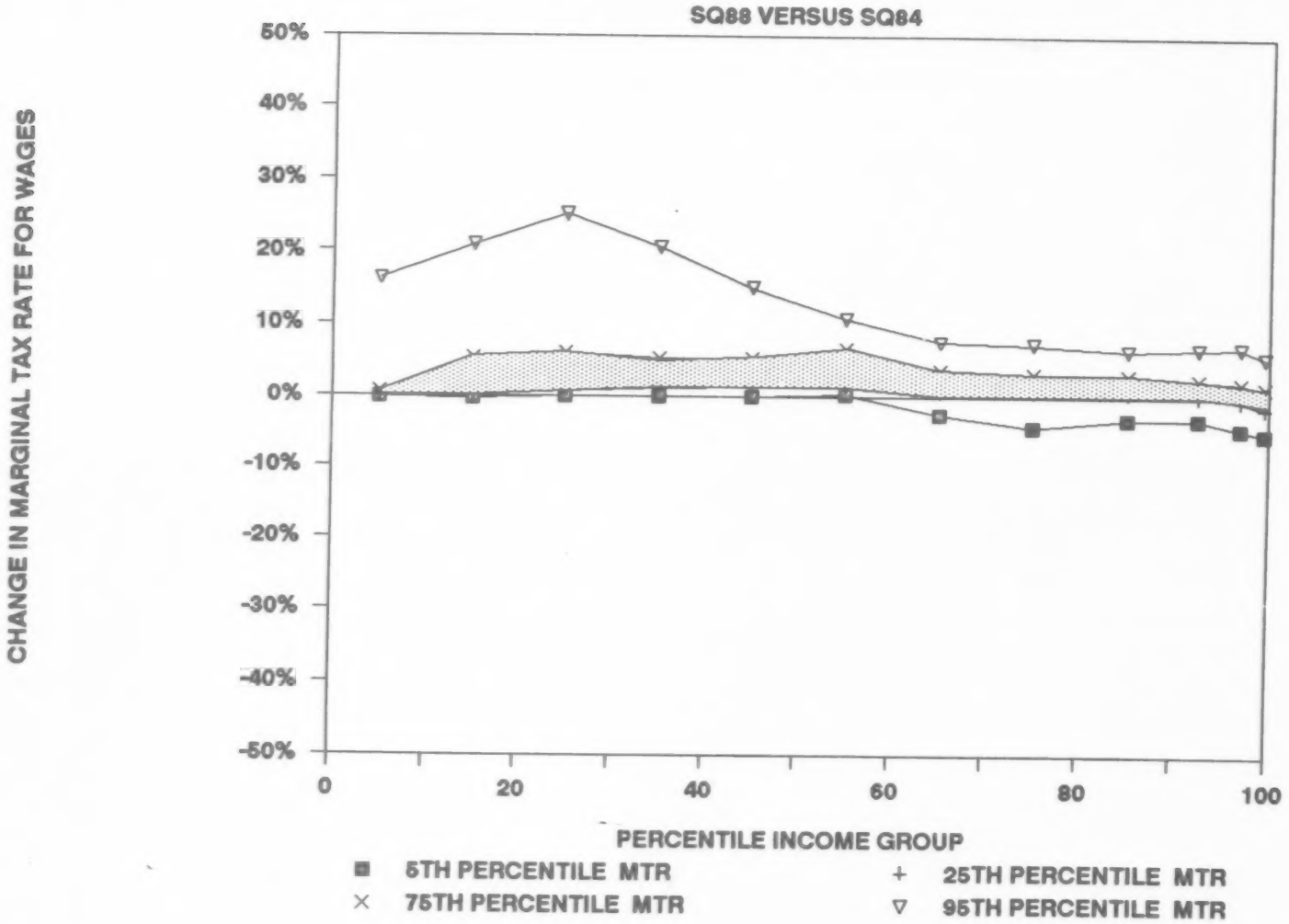
9. VARIATIONS IN MARGINAL TAX RATES FOR WAGES



10. VARIABILITY IN MARGINAL TAX RATES FOR WAGES



11.1 CHANGE IN MTRs FOR WAGES



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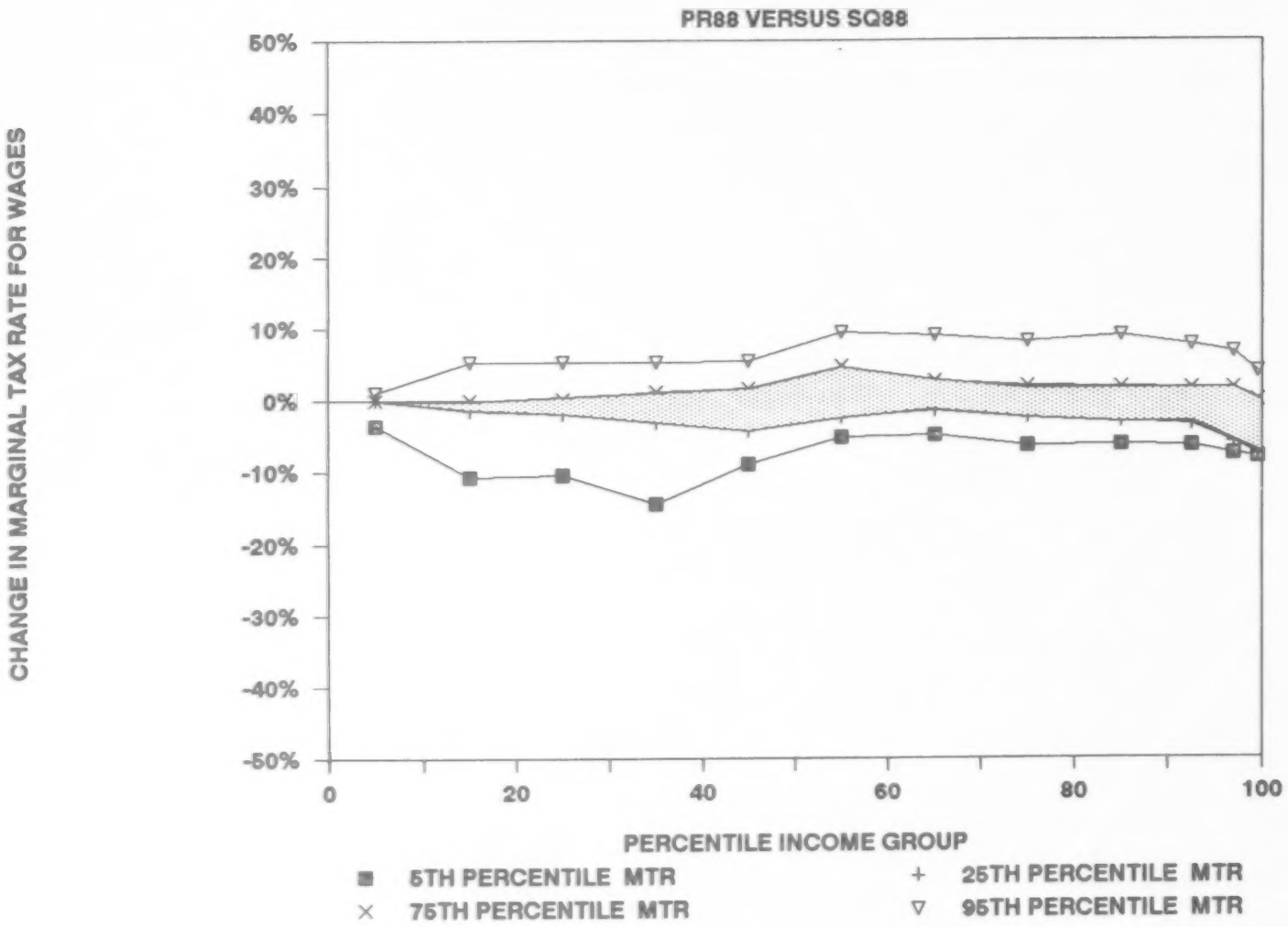
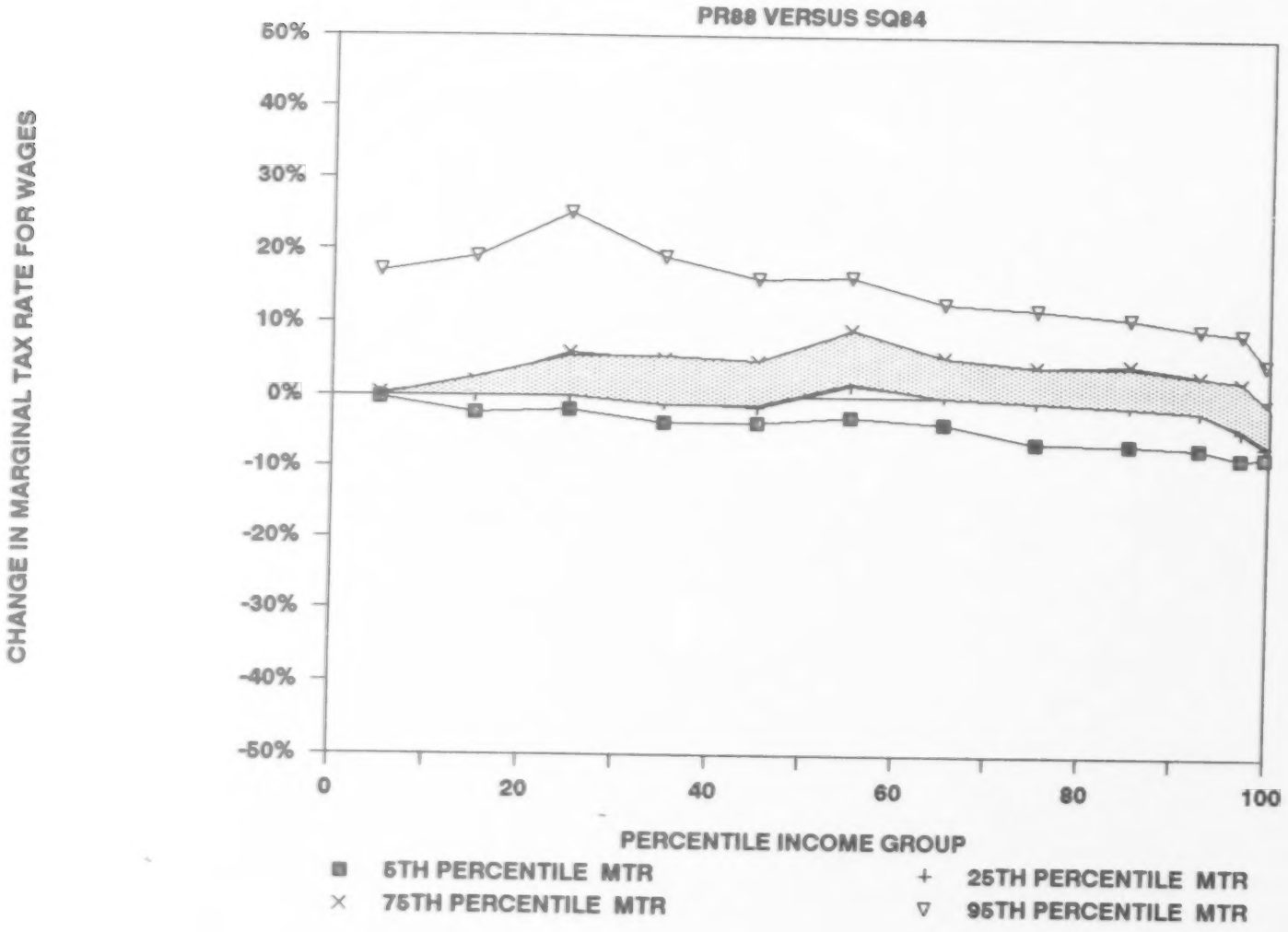
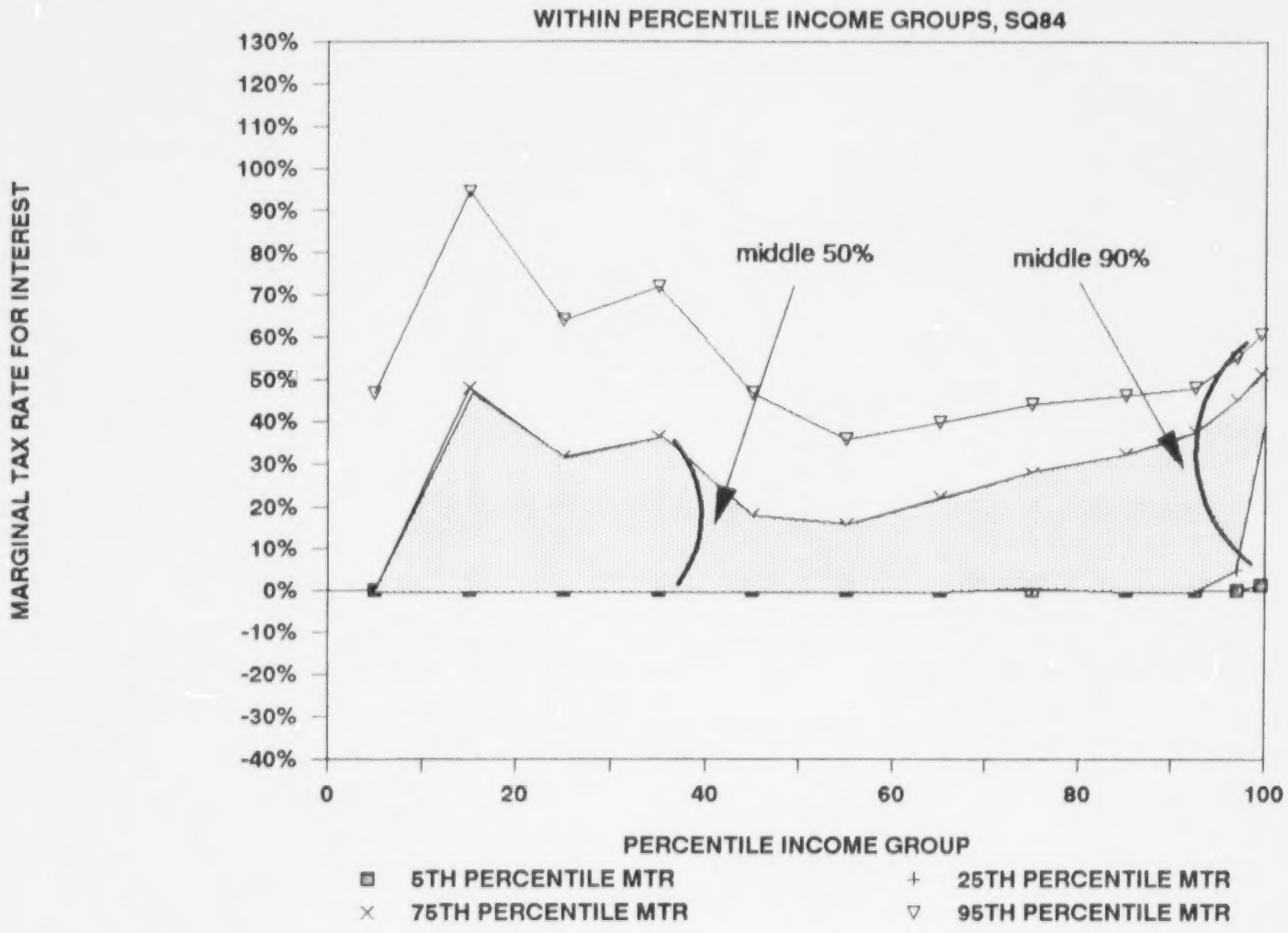


11.3 CHANGE IN MTRs FOR WAGES



12. VARIATIONS IN MTRS FOR INTEREST



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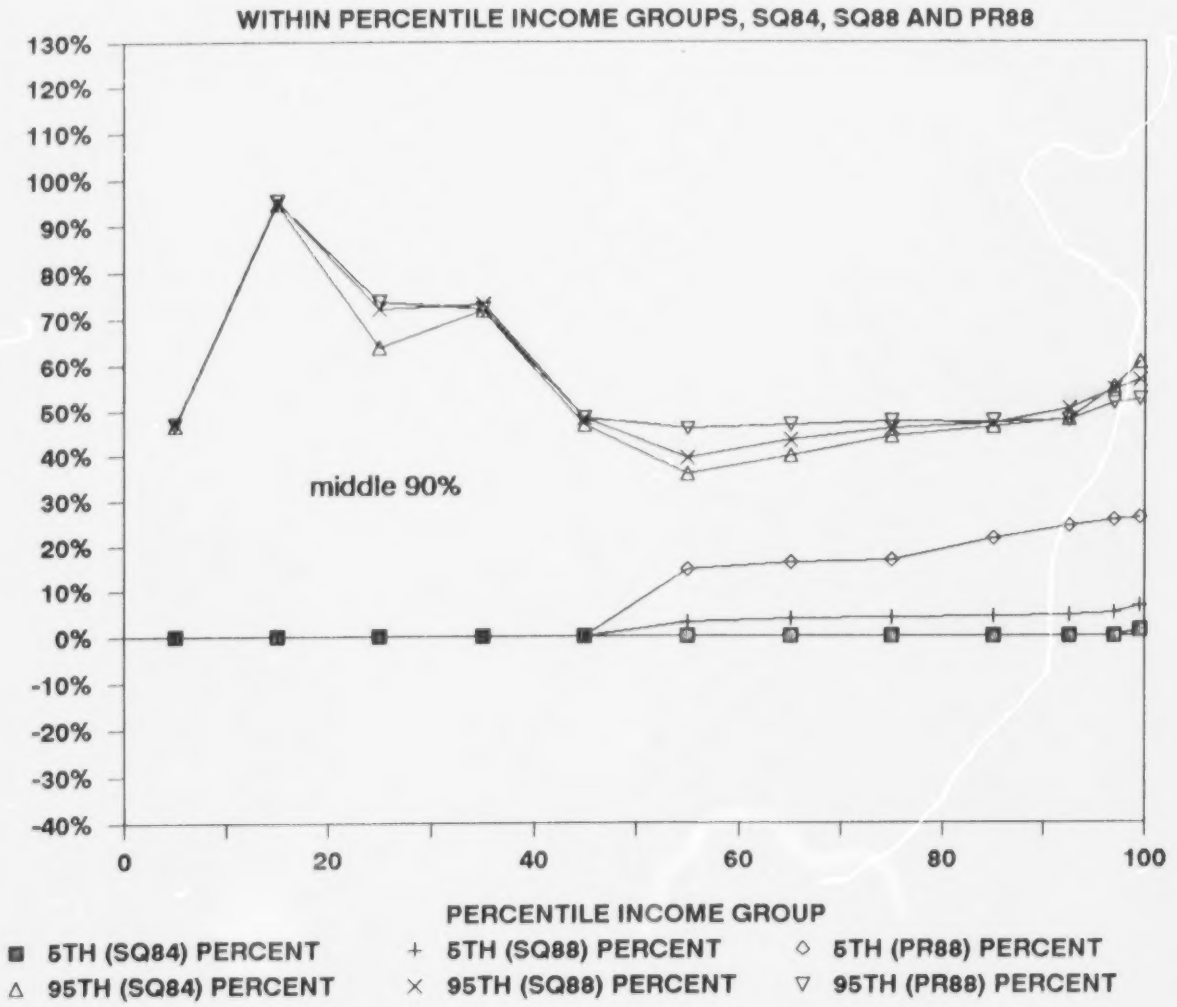

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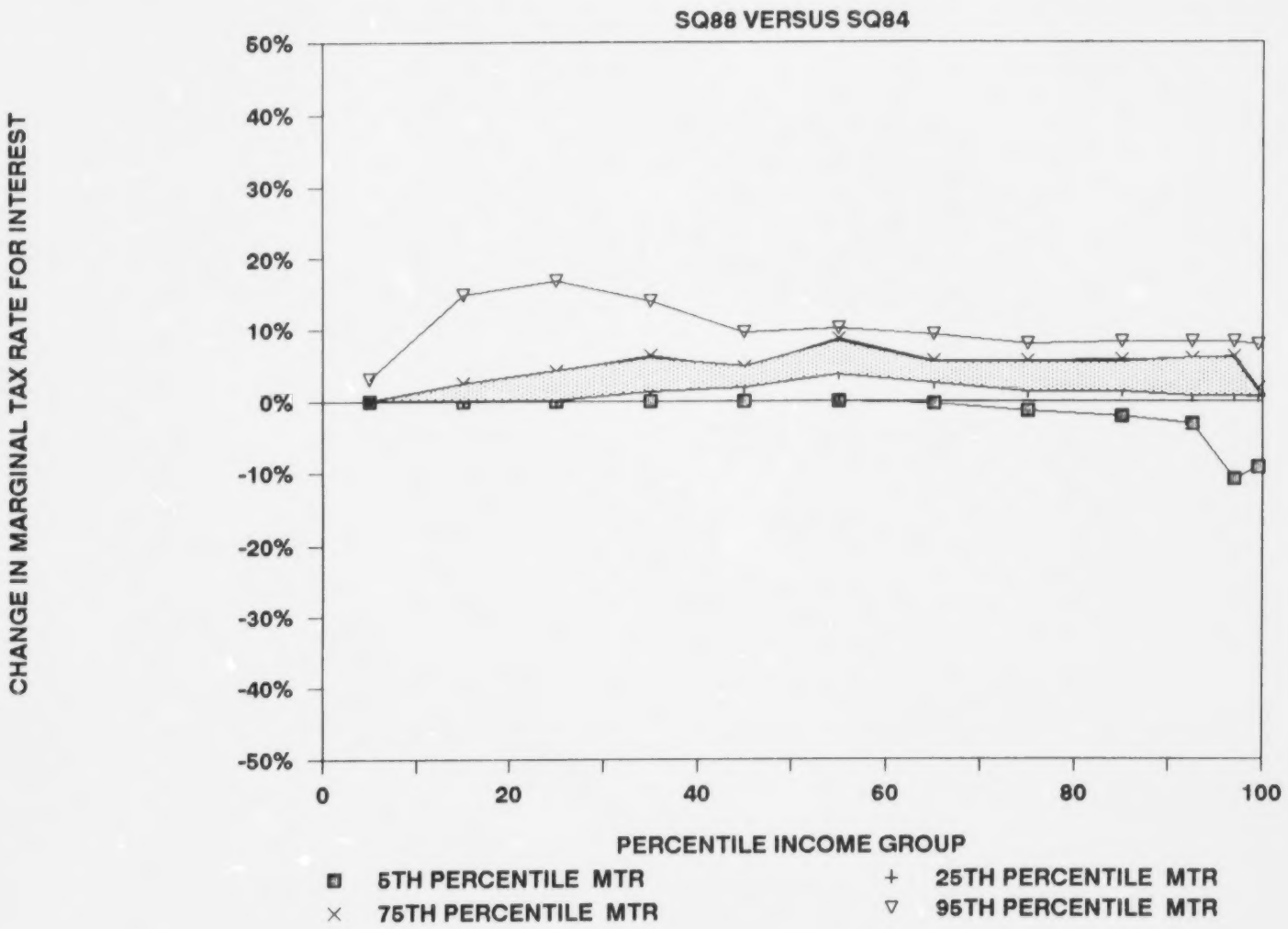

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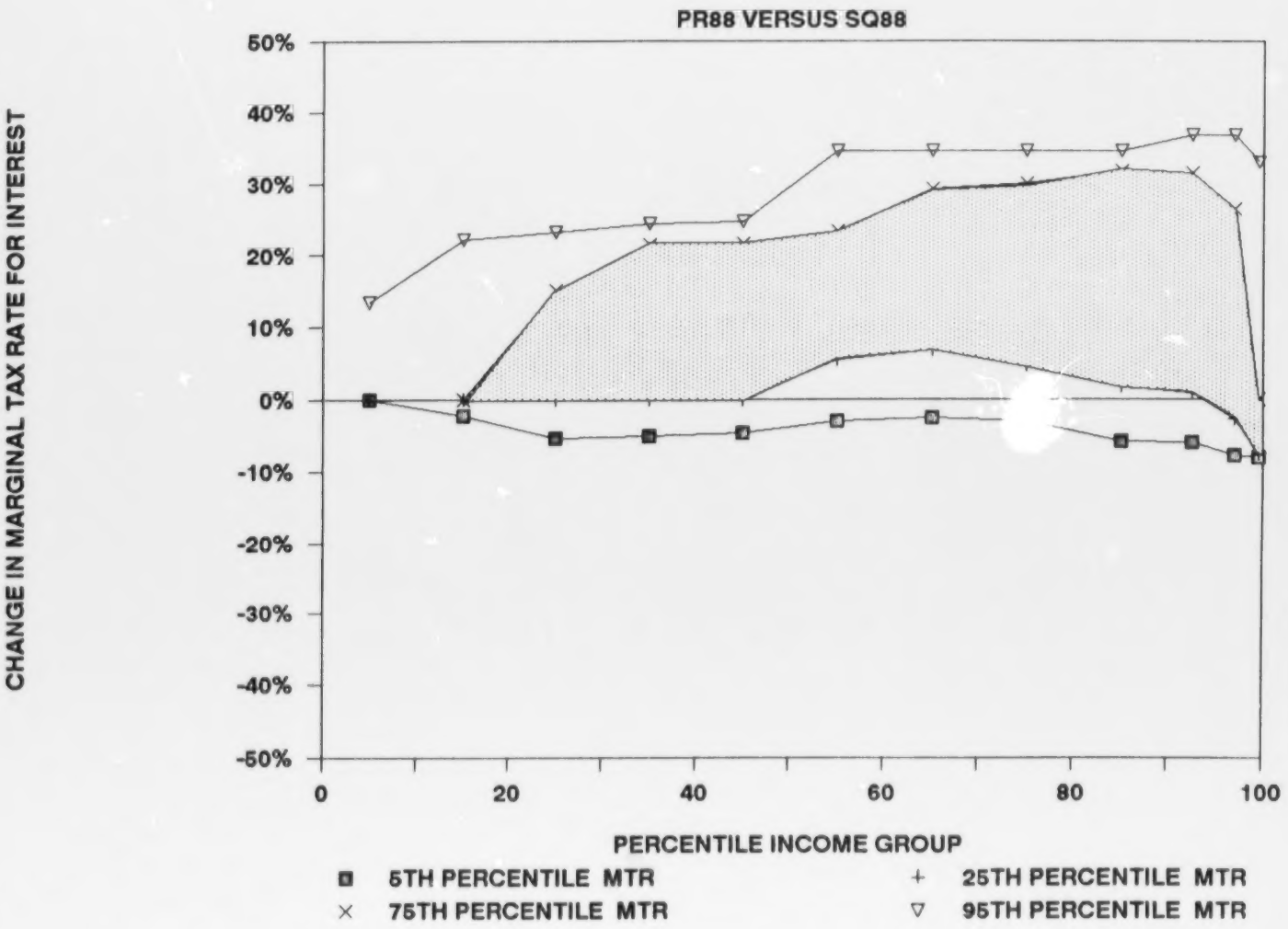

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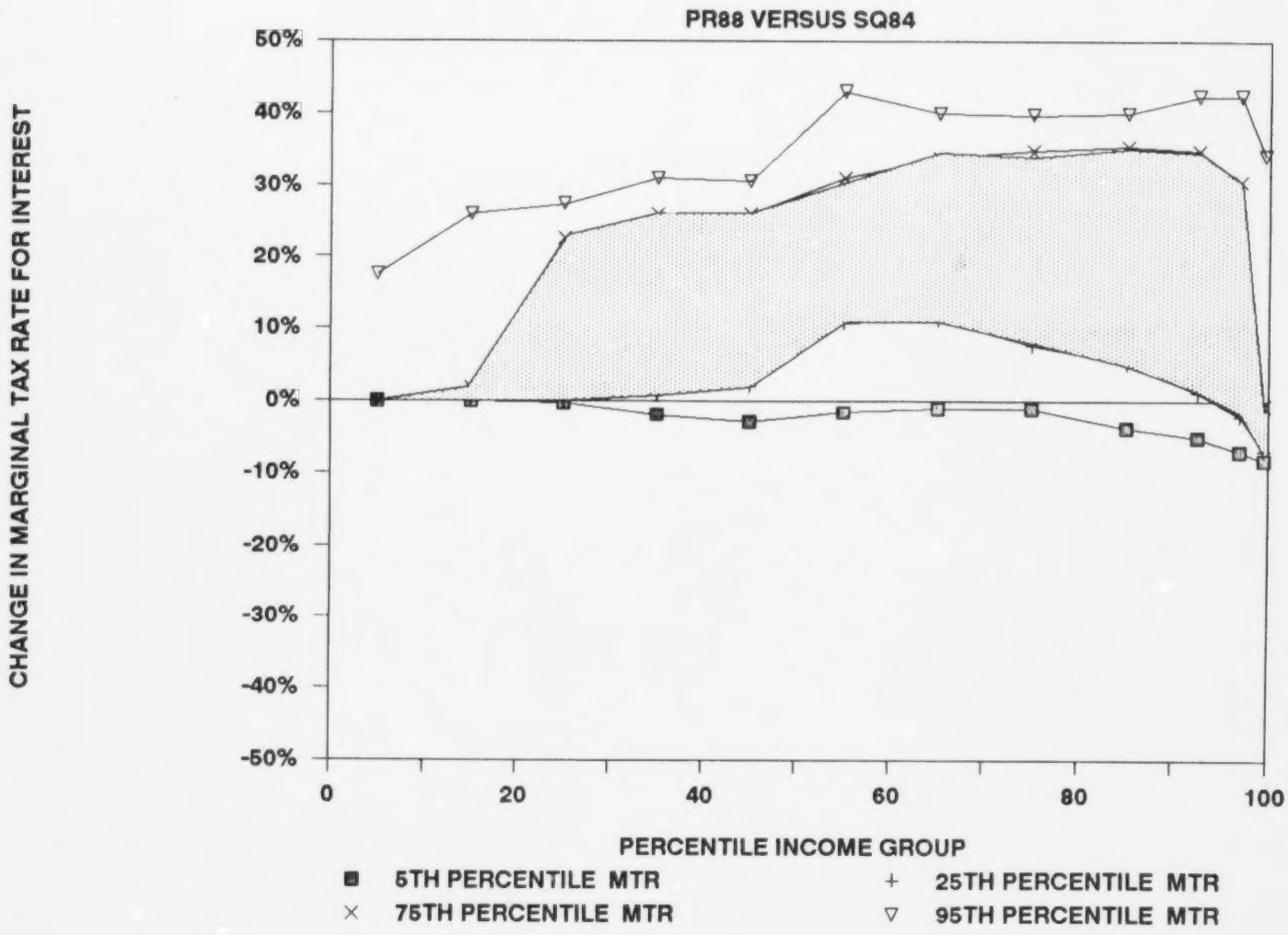
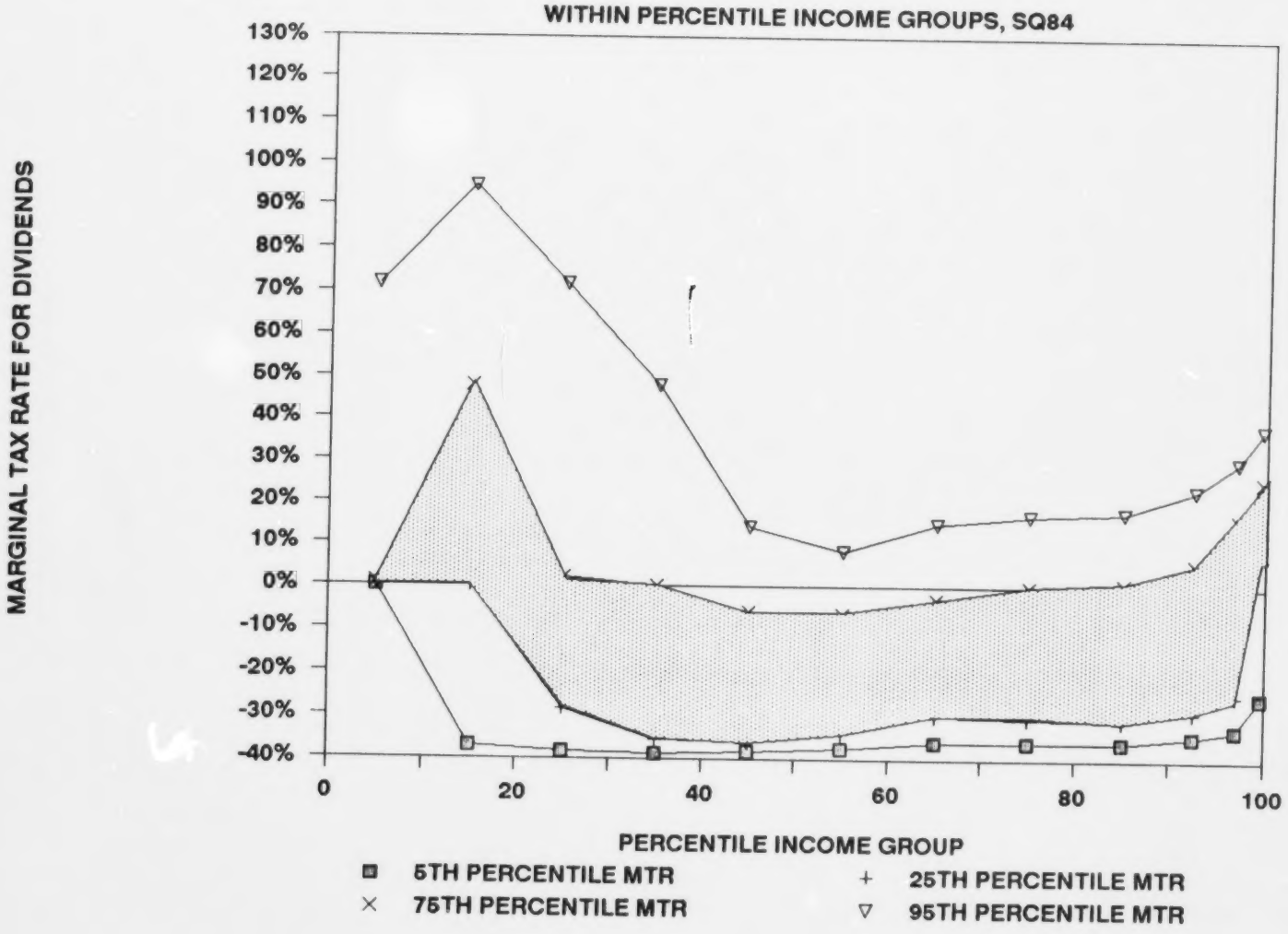


15. VARIATIONS IN MTRS FOR DIVIDENDS



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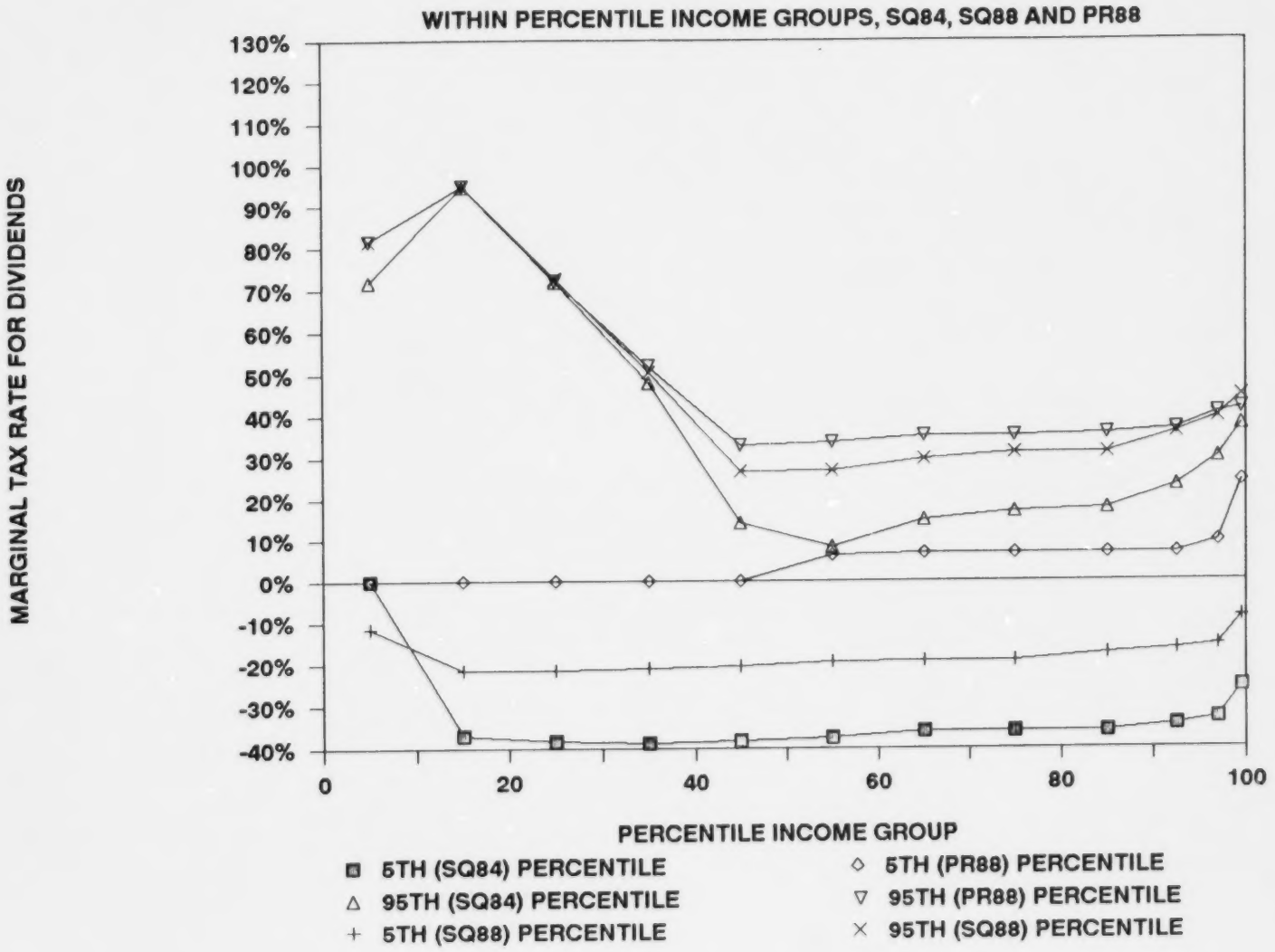

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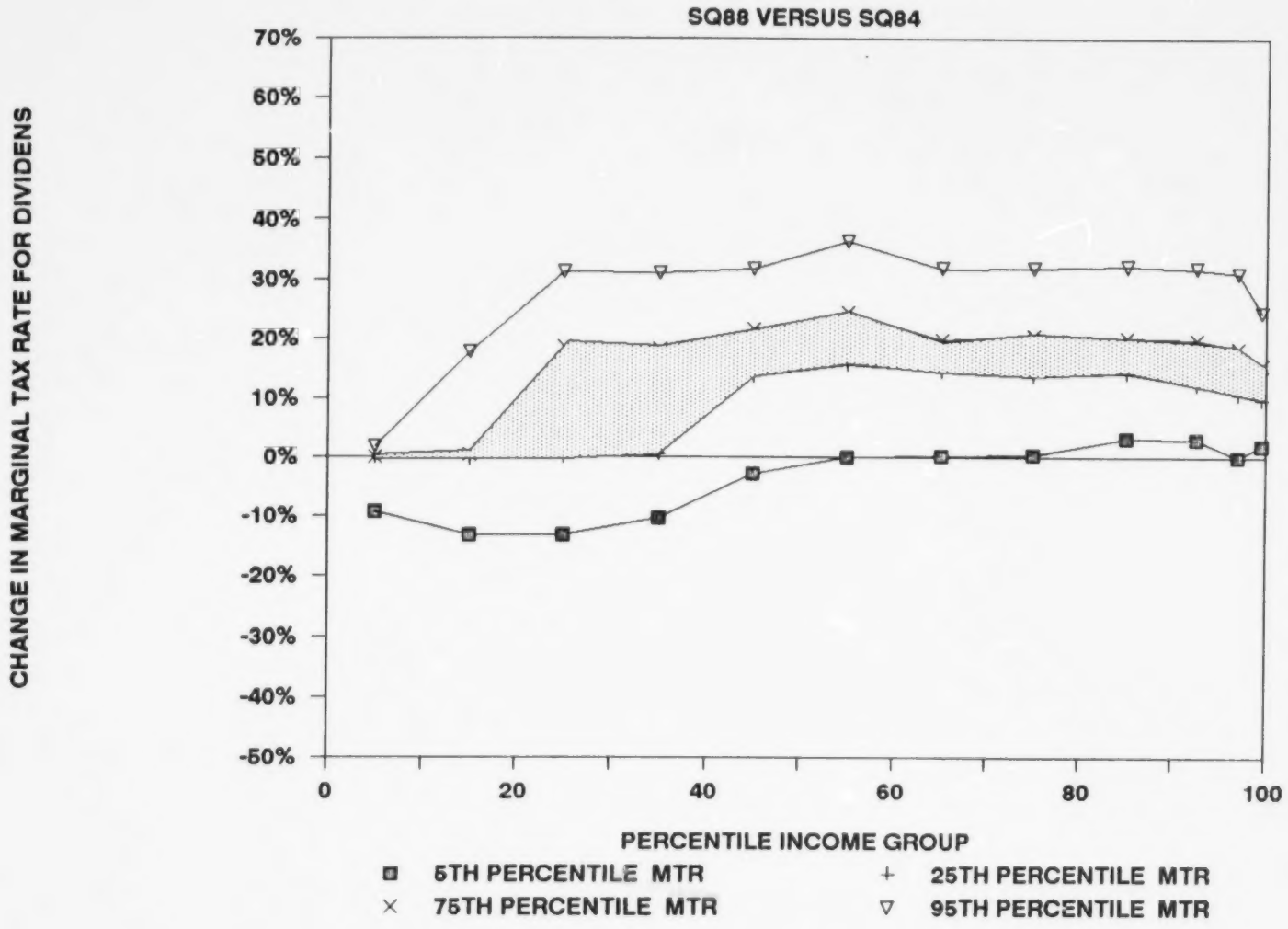

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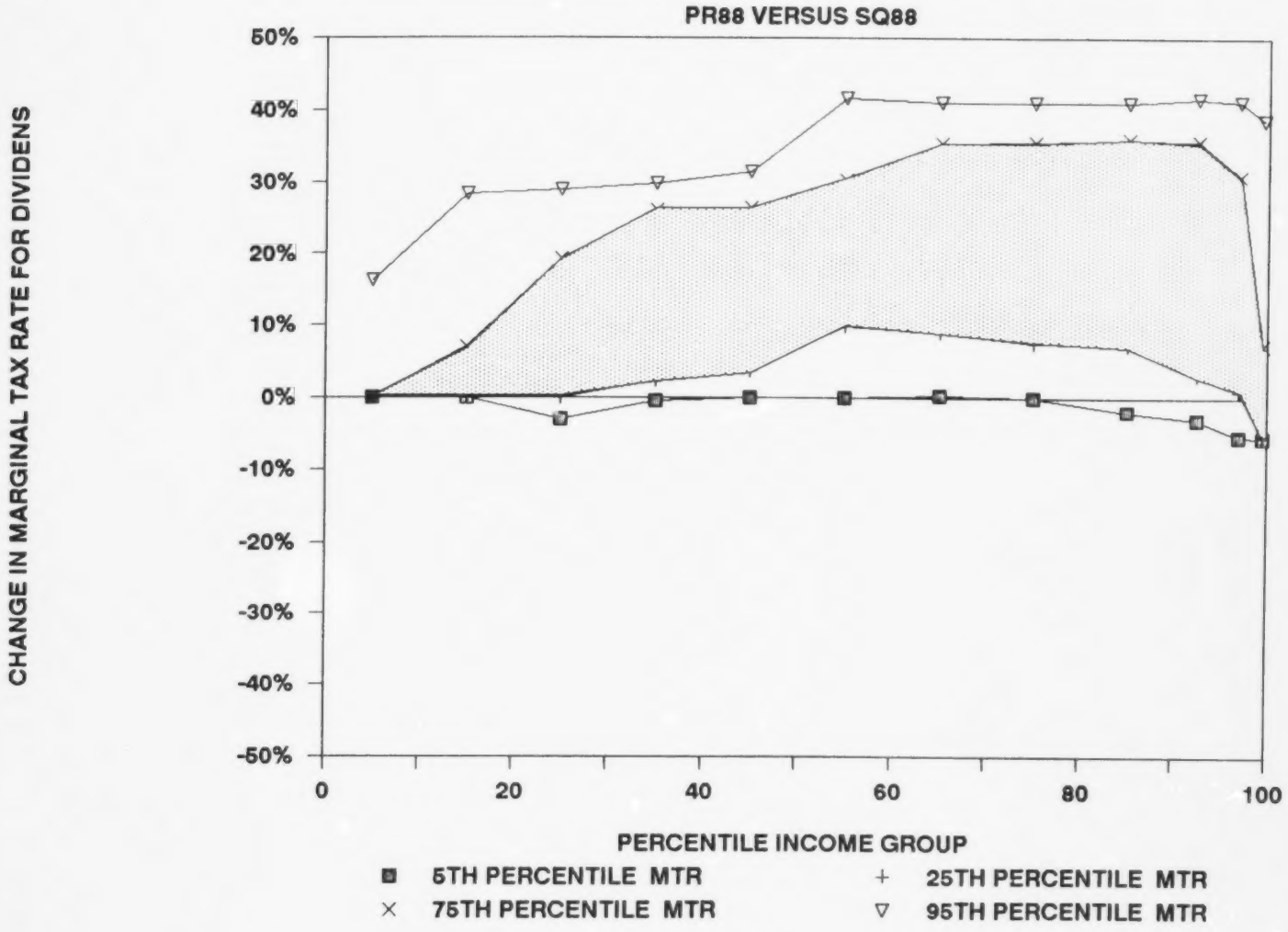

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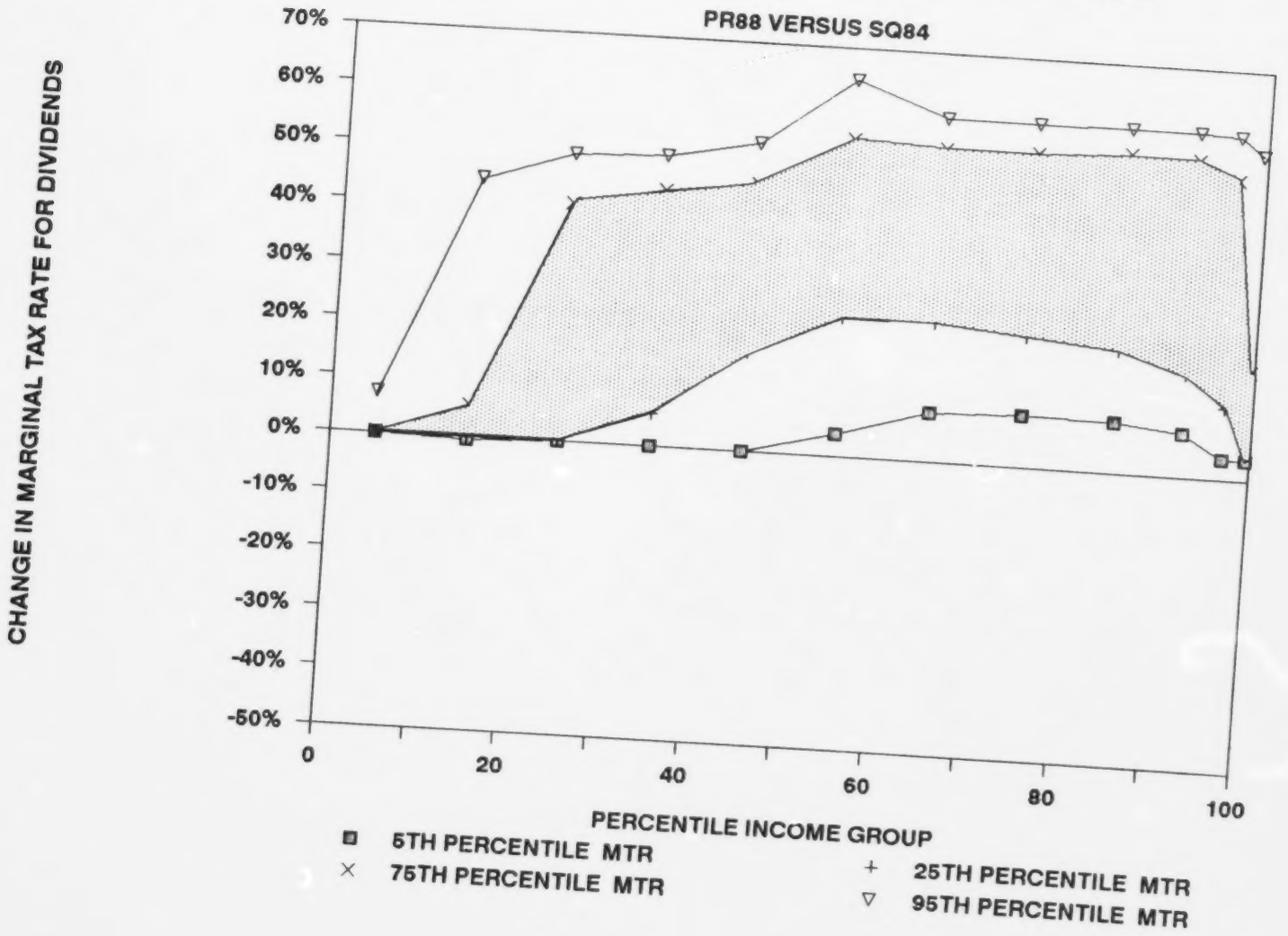
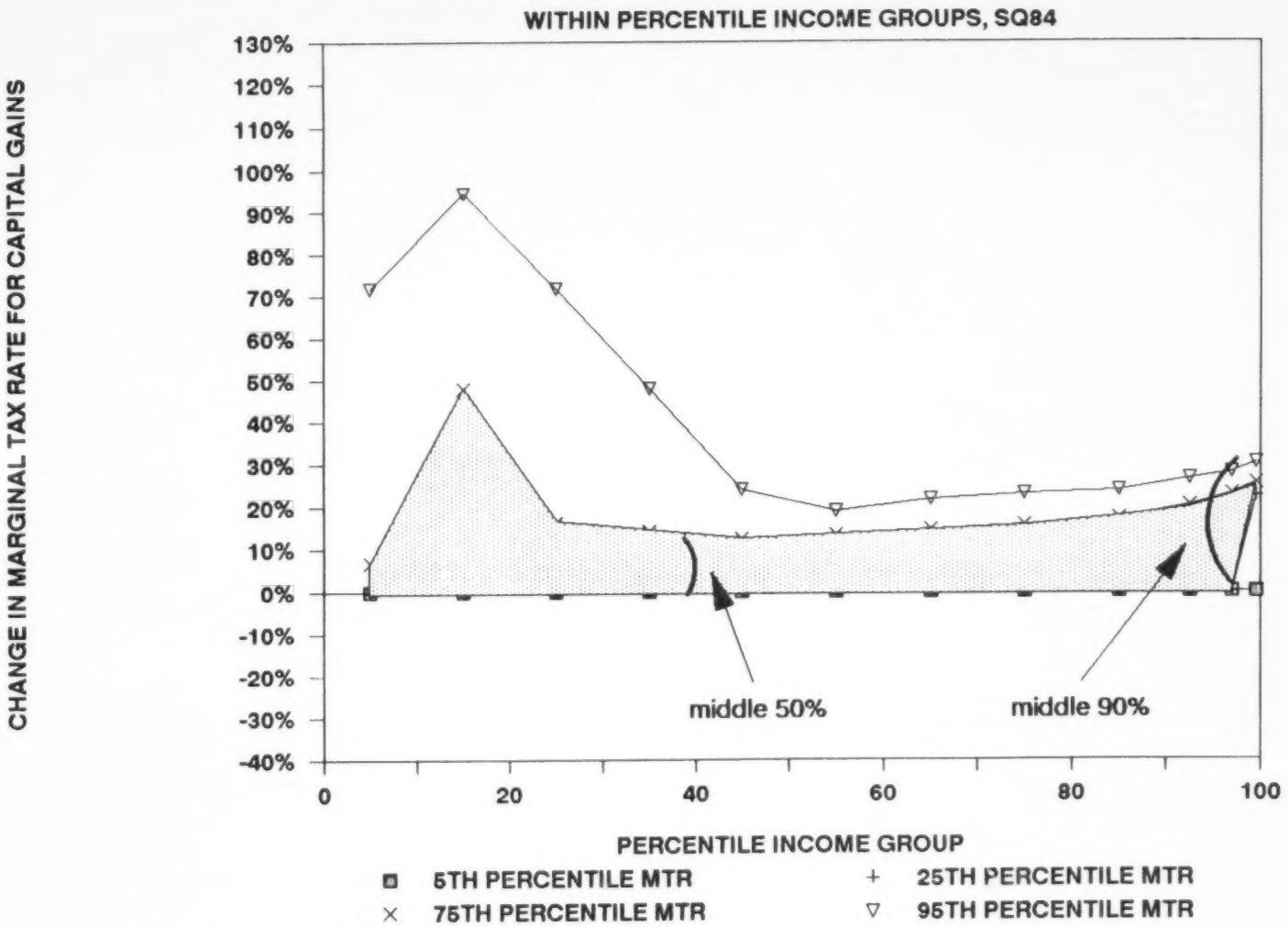


18. VARIATIONS IN MTRS FOR CAPITAL GAINS



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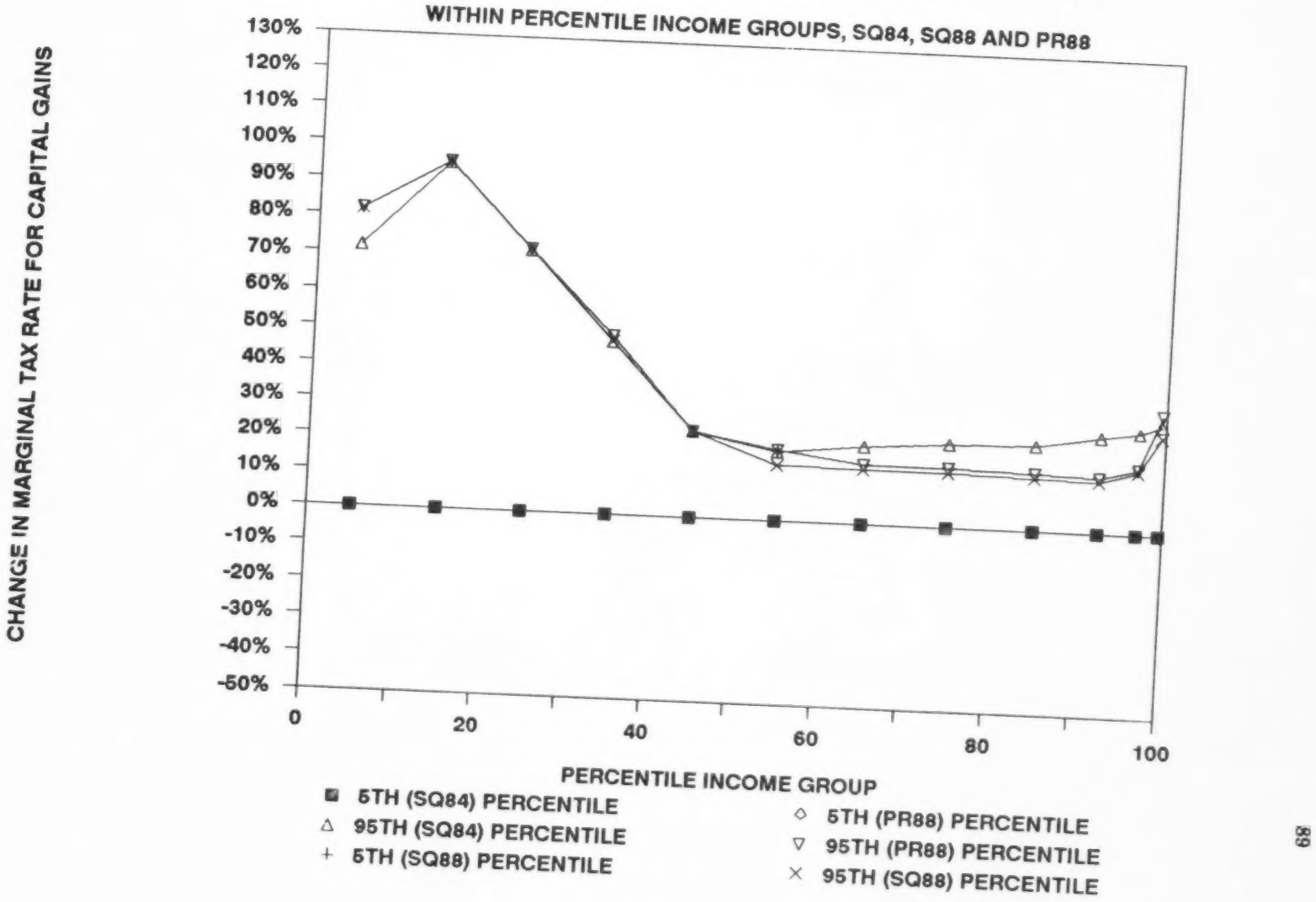
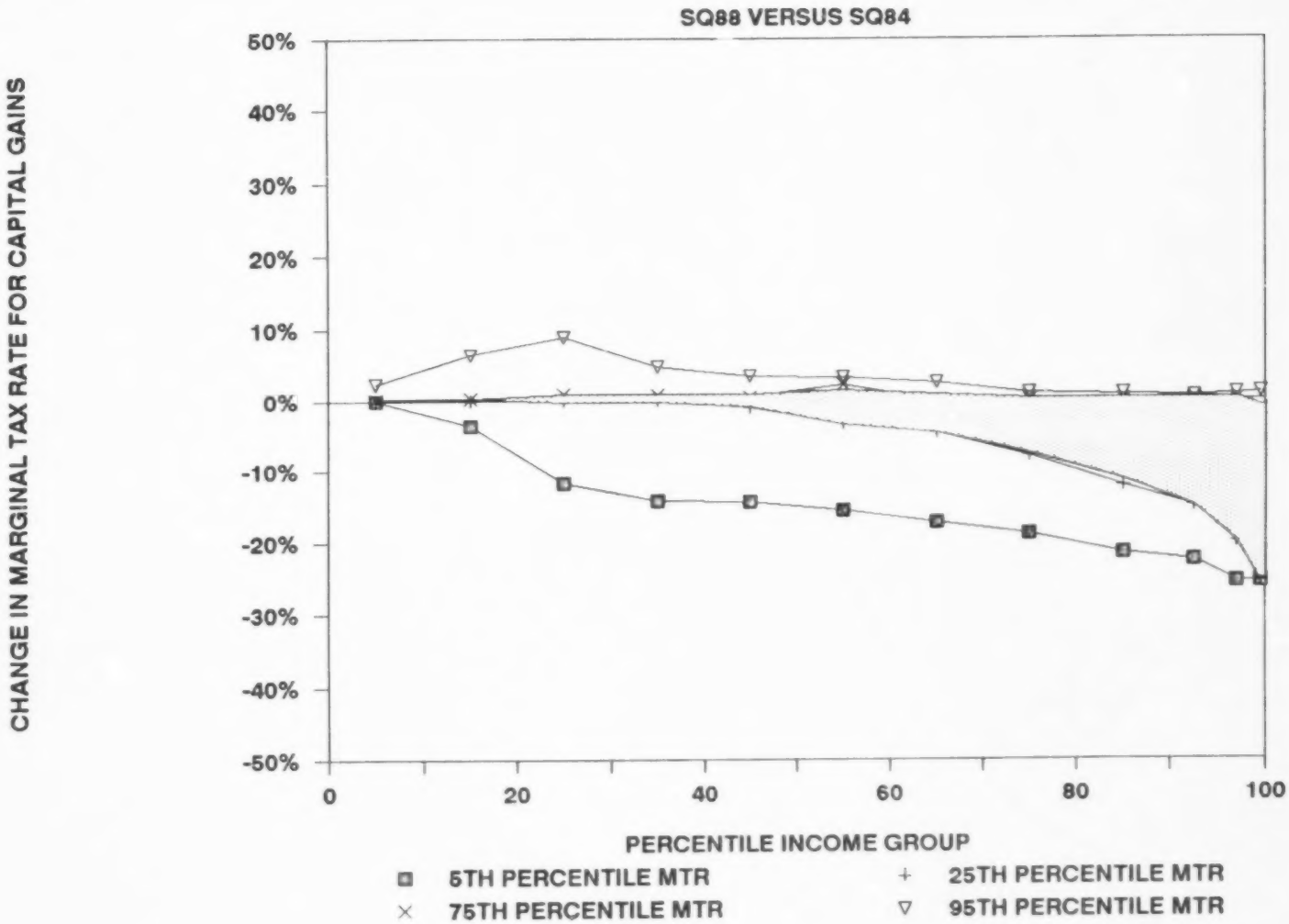
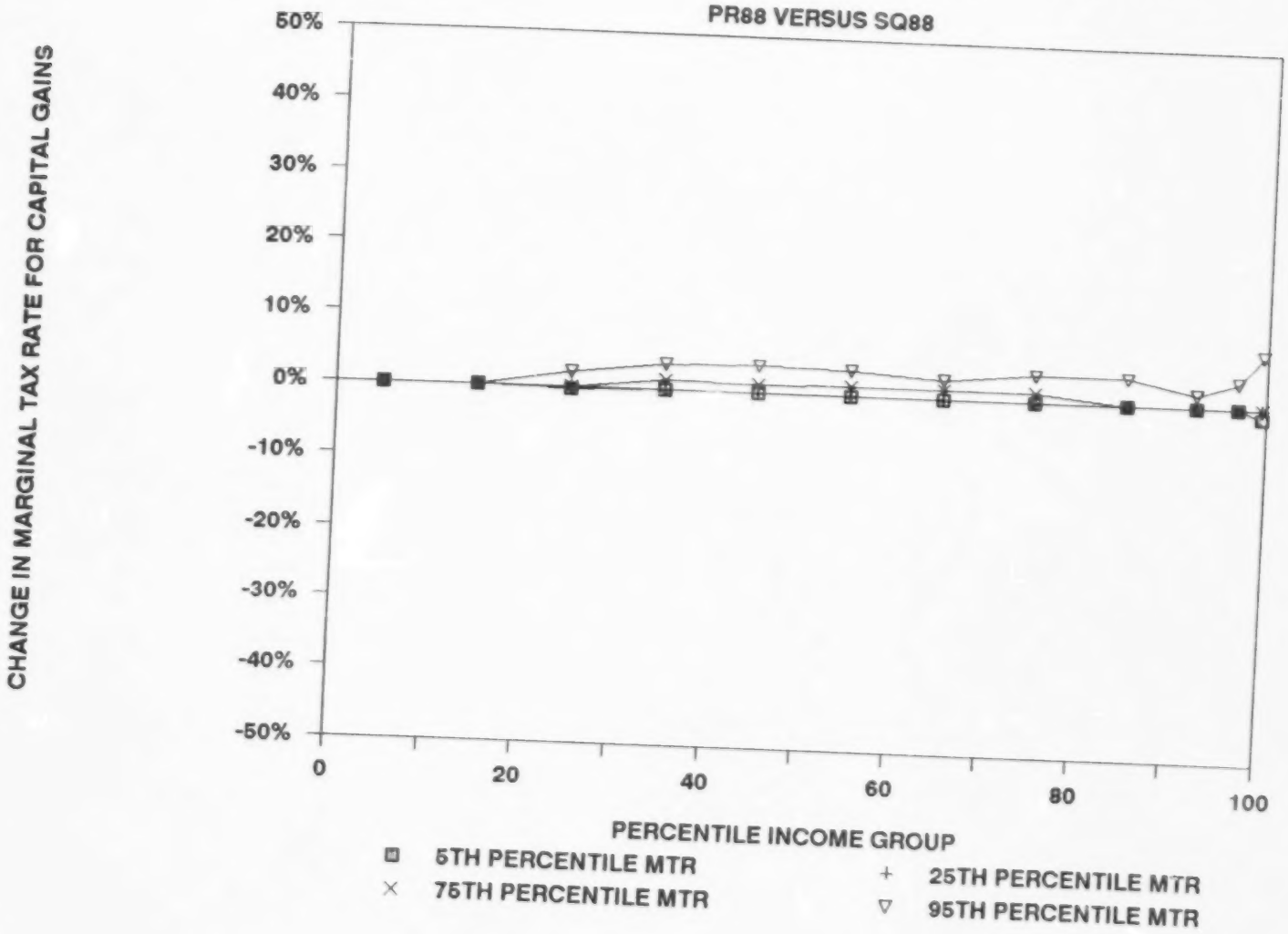


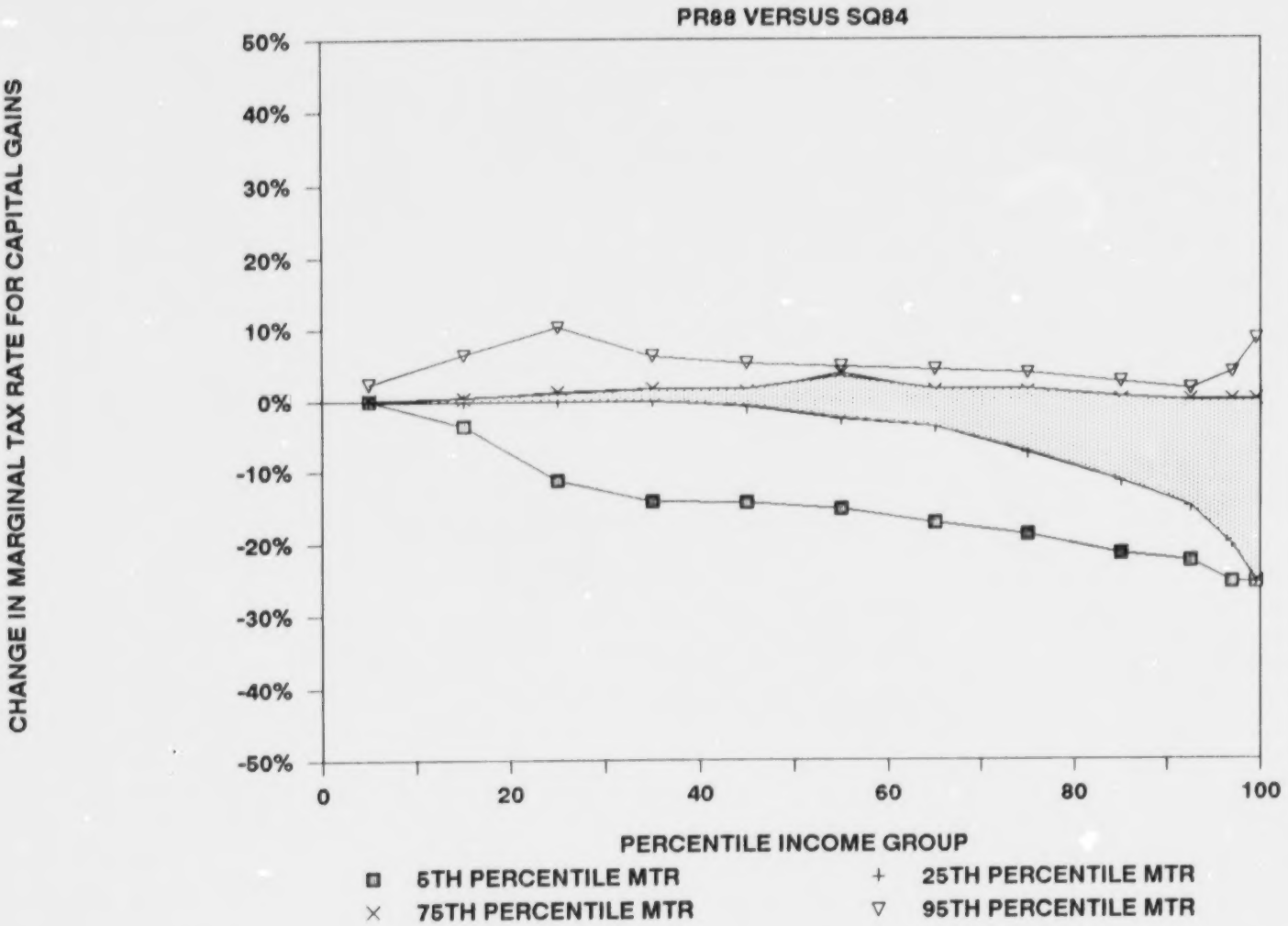
20.1 CHANGES IN MTRS FOR CAPITAL GAINS



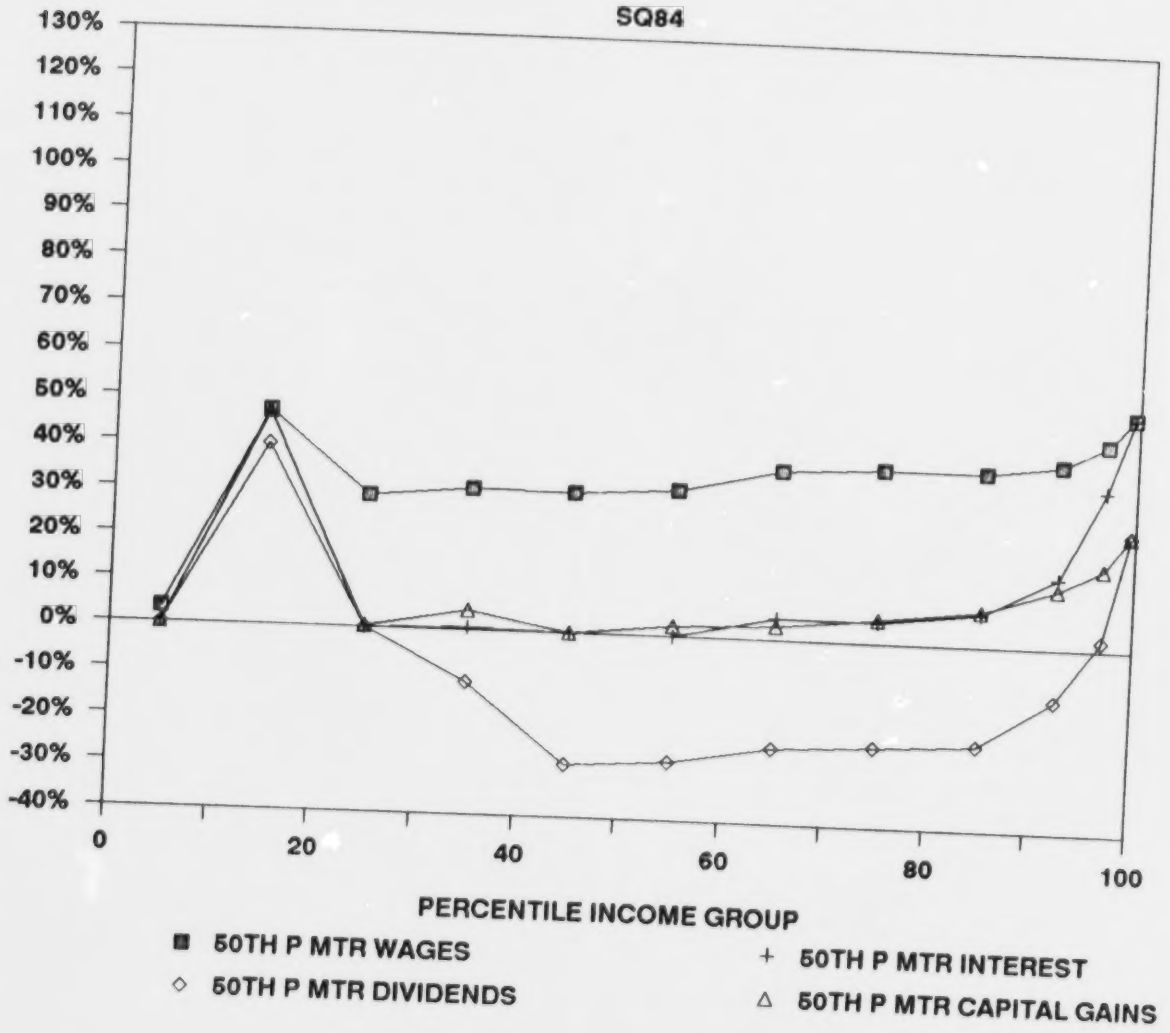
20.2 CHANGE IN THE MTRS FOR CAPITAL GAINS



20.3 CHANGE IN MTRS FOR CAPITAL GAINS



21.1 VARIATIONS IN MARGINAL TAX RATES



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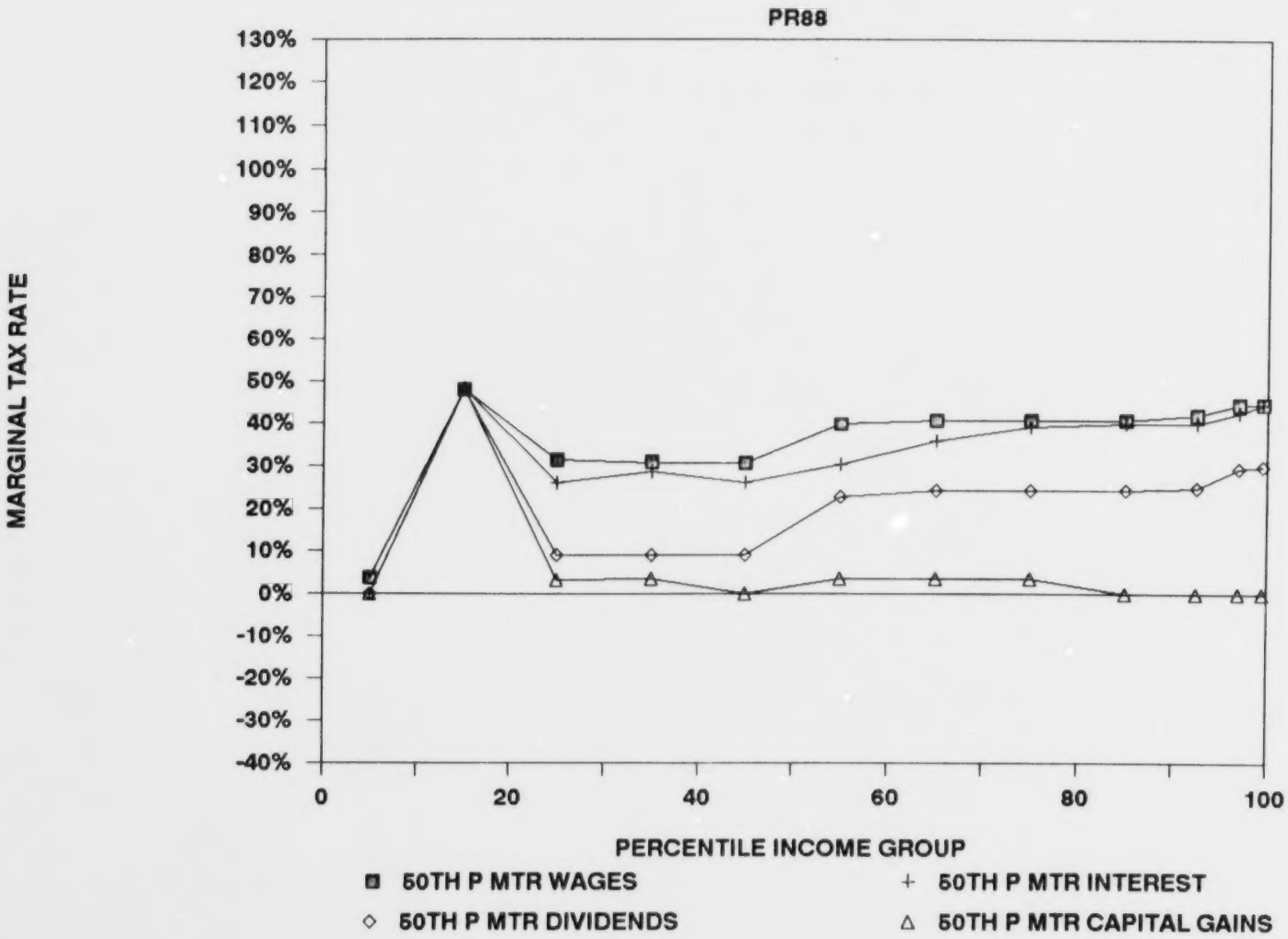
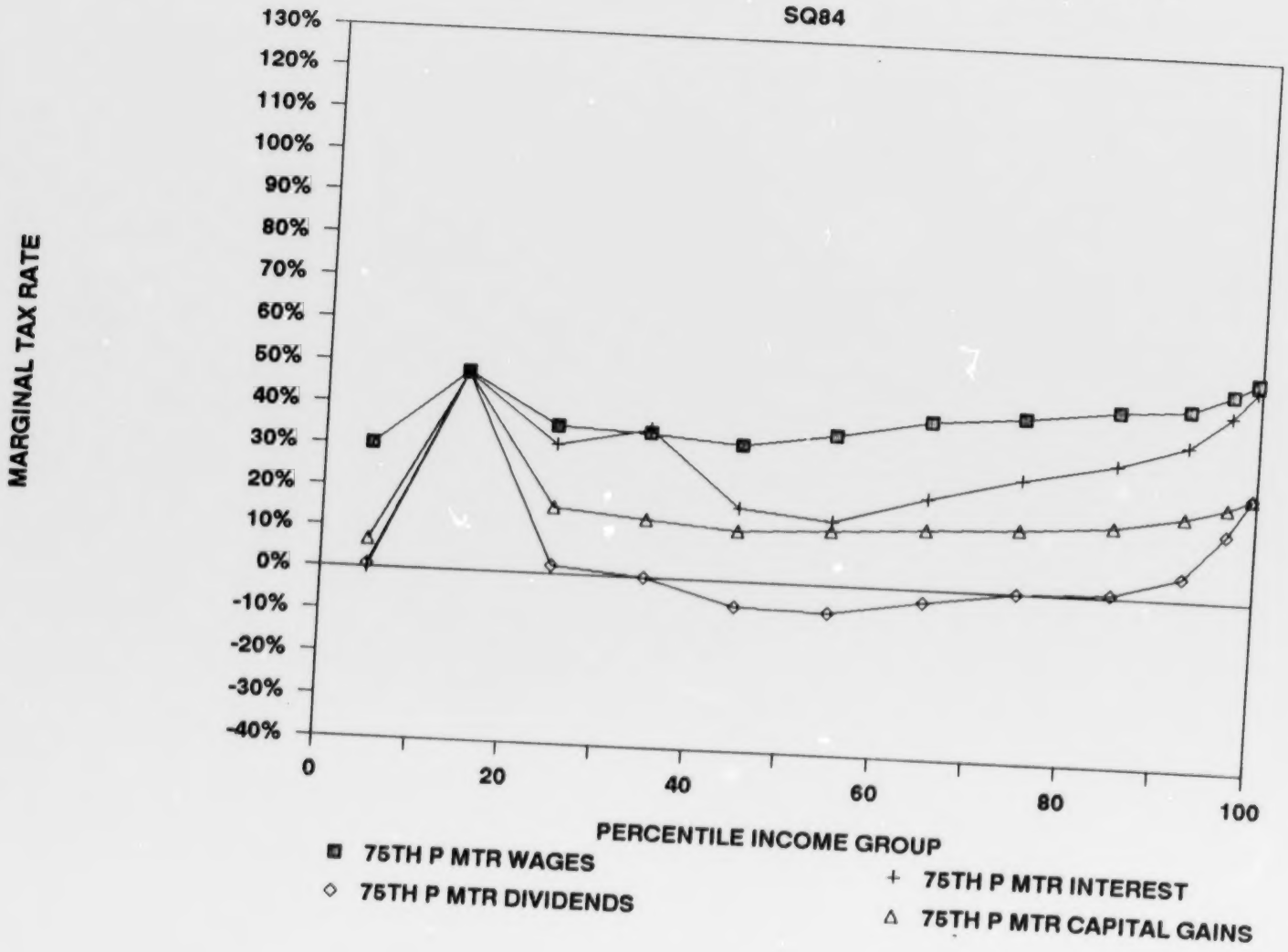
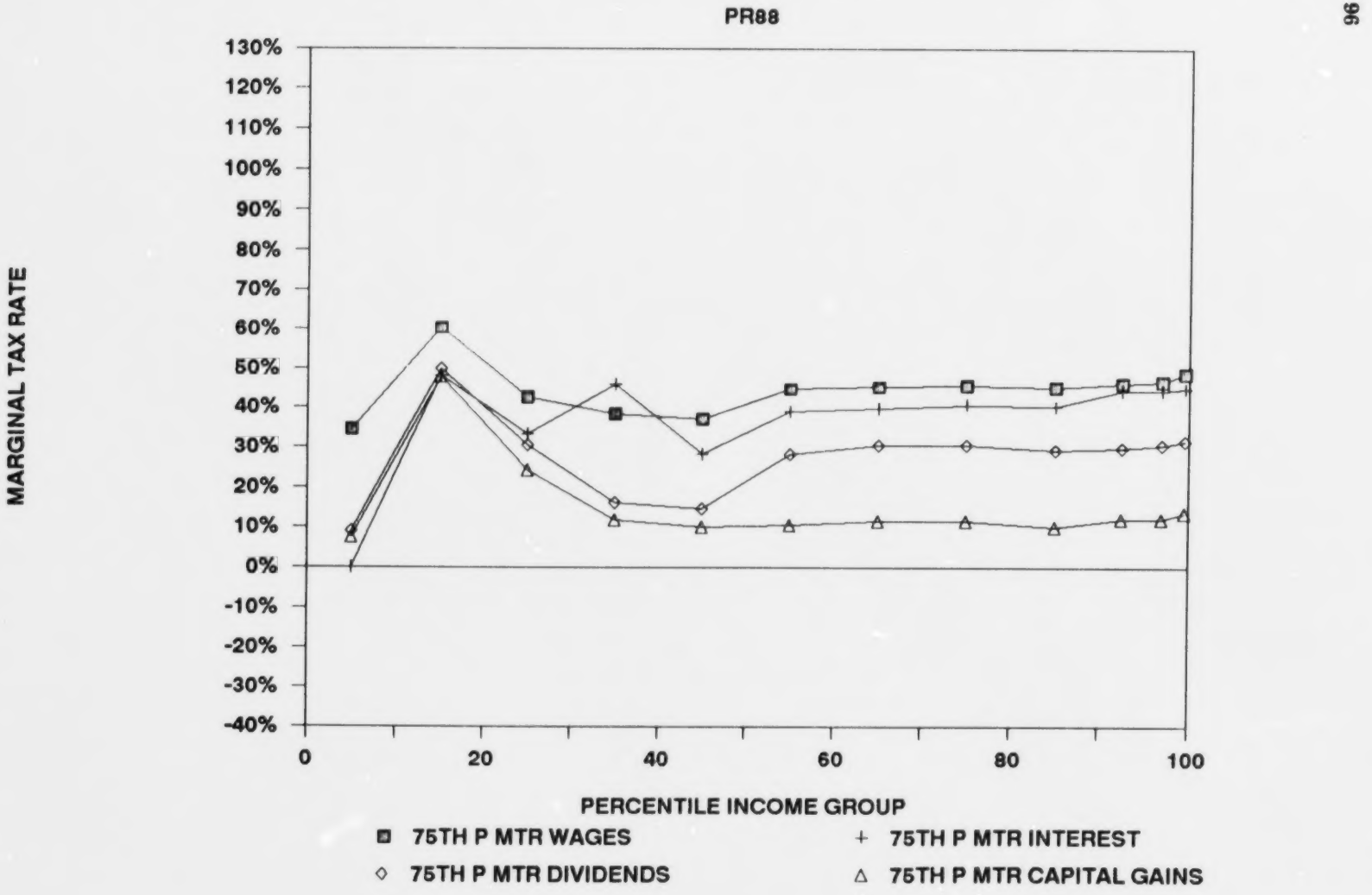


21.3 VARIATIONS IN MARGINAL TAX RATES



21.4 VARIATIONS IN MARGINAL TAX RATES



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Tax Reform in Canada:
the process and impact

by Allan M. Maslove

Tax Reform in Canada: the process and impact by Allan M. Maslove contains two essays. In the first, Maslove analyzes the delicate balance between the two major purposes for which governments use tax systems: raising revenues and pursuing other economic and social goals. The need to strike this balance complicates efforts to design a fair and efficient tax system and often provokes prolonged struggles among groups in society with vested interests in one tax instrument or another. As a result, Canada's experience with tax has often been troubled. The Conservative government's 1987 income tax reform enjoyed greater political success, however, for reasons Maslove examines in this essay.

In the second essay Maslove uses a computer model to simulate the effects of income tax reform on disposable incomes and the distribution of the tax burden. Maslove concludes that income tax reform in the 1980s is the product of a clear agenda on the part of the Progressive Conservative government, an agenda that emphasizes greater reliance on market forces and reduced influence of tax considerations as a factor in individual and corporate economic decisions.

In publishing these essays, the Institute for Research on Public Policy hopes to contribute constructively to public debate on the optimal structure for Canada's tax system and to offer a foundation for analyzing the overall effects of tax reform on the distribution of the tax burden.

Allan Maslove conducted the research for these essays as a Scholar-in-Residence associated with the Institute's Studies in Social Policy Program. He is a professor in the School of Public Administration at Carleton University.

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